

**CROSS BORDER ISSUES UNDER THE CANADA-U.S. TREATY:
U.S. CHARITIES OPERATING IN CANADA**

A Paper

By

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December 17, 2007

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ABSTRACT

The scope of the operations of many charities has become increasingly international in recent years. Often, many U.S. charities will have operations in Canada, including soliciting donations and earning income from various sources. This paper reviews the treatment of cross-border charitable giving by Canadian donors to U.S. charities under Article XXI(6) of the *Canada-United States Income Tax Convention* (1980). Comparison will be made to the reciprocal application of Article XXI(5) to charitable giving by U.S. donors to Canadian charities. This paper also reviews the circumstances under which U.S. charities operating in Canada would be exempt from Canadian tax under Articles XXI(1) of the Treaty and as non-profit organizations under the *Income Tax Act* (Canada). However, the interpretation of the applicable provisions of the Treaty is often not entirely clear. Furthermore, the application and interpretation of the reciprocal provisions of the Treaty in Canada and the U.S. is not consistent. Such inconsistency may lead to further uncertainty in relation to the application of the Treaty.

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A. INTRODUCTION

The scope of the operations of many charities has become increasingly international in recent years. It is not unusual for U.S. charities to have operations in Canada, *e.g.*, soliciting donations, carrying on charitable activities, holding conferences and workshops, selling merchandise to further their charitable objects, etc. Similarly, many Canadian charities have operations in the U.S. Relief is provided under the *Canada-United States Income Tax Convention* (1980) (the “Treaty”)¹ on cross-border charitable giving and exemption from income tax between the two contracting states. The Treaty first came into effect in 1985, which “represented unprecedented breakthrough in U.S. policy regarding cross-border gifts.”²

Many U.S. charities desire to receive donations from the general public in Canada. Article XXI(6) of the Treaty provides U.S. charities with the ability to receive donations from Canadian donors and issue donation receipts with which the donors may claim tax relief in Canada within certain limits. Reciprocal benefits are available to U.S. donors who make charitable donations to Canadian

¹ Convention Between Canada and The United States of America with respect to Taxes on Income and on Capital Signed on September 26, 1980, as Amended by Protocols Signed on June 14, 1983, March 28, 1984, March 17, 1995 and July 29, 1997 (herein referred to as the “Treaty”). Enacted in Canada by S.C. 1984, c. 20; 1995 Protocol enacted in Canada by S.C. 1995, c. 34, Royal Assent November 8, 1995; 1997 Protocol enacted in Canada by S.C. 1997, c. 38, Royal Assent December 10, 1997. The Fifth Protocol to the Treaty was signed on September 21, 2007, after having been negotiated the past 10 years. It introduces many changes to the Treaty, including elimination of withholding tax on interest, extension of treaty benefits to owners of limited liability companies, modification of rules dealing with residence and corporate emigration, and changes to the ways in which various personal tax considerations are handled. The Fifth Protocol comes into effect the later of January 1, 2008 and day when both governments have completed their constitutional and statutory requirements to ratify the Protocol and have exchanged their instruments of ratification. Bill S-2 received Royal Assent on Friday December 14, 2007, as *An Act to amend the Canada-United States Tax Convention Act, 1984, 2007*, c. 32, so that Canada has now completed the steps required in this country to give effect to the fifth Protocol to the Canada-United States Income Tax Convention. The Fifth Protocol is available on the Department of Finance’s website at http://www.fin.gc.ca/treaties/USA_1e.html. For a review of the changes introduced by the Fifth Protocol, see Amanda Heale and Tania Ng, “Treaty Update”, *Taxation Law Newsletter* Vol 18, No. 1, December 2007 at 6 to 14 (Ontario Bar Association); and William Holms and Ken Bутtenham, “Canada-U.S. Income Tax Treaty: Fifth Protocol Makes Major Changes”, *Tax Topics* No. 1856 (Toronto: CCH Canadian, October 4, 2007) 7-10.

² Jane Peebles, “Cross-Border Philanthropy,” March 21, 2007 at 20. See also Joannie Chang, Jennifer I. Goldberg and Naomi J. Schrag, “Cross-Border Charitable Giving” 31 *University of San Francisco Law Review* (Spring 1997) 563 at 602-603.

charities pursuant to Article XXI(5) of the Treaty. Additional limited relief on receipting cross-border gifts by Canadian donors is also provided under the *Income Tax Act* (Canada) (the “Act”).³

In addition to soliciting donations from Canadian donors, many U.S. charities also carry on operations in Canada. Since U.S. charities do not have charitable status under paragraph 149.1(1) of the Act, their operations may not necessarily be exempt from income tax in Canada. As non-residents in Canada, income earned by U.S. charities in Canada may be subject to non-resident taxes in Canada, unless they fall within one of the number of exemptions provided for under the Treaty or the Act.

In this regard, Article XXI(1) allows reciprocal recognition of tax exemption status for “religious, scientific, literary, educational or charitable organizations” so that certain income earned by U.S. charities in Canada is exempt from Canadian tax under the Act. Similarly, certain income earned by Canadian charities in the U.S. is exempt from U.S. tax under the U.S. *Internal Revenue Code* (the “Code”).⁴ If a particular charity does not qualify for exemption under Article XXI(1), its income may be exempt under other provisions of the Treaty, *e.g.*, certain income may be exempt from tax pursuant to Article VII of the Treaty by virtue of the income not being business profits derived from a permanent establishment in the other country. In addition, other relief may be provided under the Act or the Code, as applicable. For example, if a U.S. charity does fit into one of the five enumerated categories of charities in the U.S., it may qualify as a non-profit organization in Canada under paragraph 149(1)(l) of the Act.

³ R.S.C. 1985, c. 1 (5th Supp.), as amended (hereinafter referred to as the “Act”).

⁴ 26 U.S.C., as amended (hereinafter referred to as the “Code”).

This paper reviews the treatment of cross-border charitable giving by Canadian donors to U.S. charities under Article XXI(6) of the Treaty. Comparison will be made to the reciprocal application of Article XXI(5) to charitable giving by U.S. donors to Canadian charities. This paper also reviews the circumstances under which U.S. charities operating in Canada would be exempt from Canadian tax under Articles XXI(1) of the Treaty and as non-profit organizations under the Act.⁵ Reference to U.S. charities in this paper will generally refer to tax-exempt organizations in the U.S. that qualify under section 501(c)(3) of the Code. Other issues involving the operation of U.S. charities in Canada, *e.g.*, payment of goods and services tax, compliance with provisional fundraising legislation, etc., are outside the scope of this paper.

One of the changes brought by the Fifth Protocol to the Treaty is to renumber Article XXI(5) and Article XXI(6) to Article XXI(6) and Article XXI(7) respectively. This will occur once the Fifth Protocol takes effect, which will be the later of January 1, 2008 and day when both governments have completed their constitutional and statutory requirements to ratify the Protocol and have exchanged their instruments of ratification. For purpose of this paper, reference will continue be made to Article XXI(5) and Article XXI(6) instead of Article XXI(6) and Article XXI(7).

B. RECEIPT OF CHARITABLE DONATIONS FROM CANADIAN DONORS

Many U.S. charities desire to receive donations from the general public in Canada. This is often one of the main reasons why U.S. charities establish parallel operating charities in Canada, which would apply to become Canadian registered charities. However, the cost and resources required to establish and maintain a parallel Canadian charity or an international charitable structure may be

⁵ An earlier version of this paper was presented at the Canadian Bar Association/Ontario Bar Association, 2007 National Charity Law Symposium on Thursday, May 10, 2007, available online at www.charitylaw.ca. This paper up-dates various

prohibitive for many U.S. charities. This would especially be the case for smaller charities, where the benefits obtained from having parallel charities in Canada may not out-weight the resources required to do so.

However, the Treaty and the Act provide U.S. charities with a limited ability to receive donations from Canadian donors and issue donation receipts with which the donors may claim tax relief within certain limits. Therefore, before a U.S. charity establishes a parallel charity in Canada, it would be prudent for it to first determine whether the relief available under the Treaty and the Act is sufficient for its intended purposes. For example, under the Treaty, Canadian donors who have U.S.-source income may claim tax relief for donations made to U.S. charities in relation to that income. Under the Act, however, donations made to a university in the U.S., that has applied and is recognized as a prescribed university in Canada under Schedule VIII of the Act, would not be restricted to U.S.-source income only. The various options available under the Treaty and the Act, in this regard, are reviewed in this section of the paper.

If the relief provided under the Treaty and the Act is not sufficient for the solicitation of donations intended by the U.S. charity, the U.S. charity may decide to establish a parallel charity in Canada. The subsequently established Canadian registered charity will need to follow the requirements of the

issues contained in the earlier paper and includes a comparison of the application of Article XXI(6) and Article XXI(5).

Act when providing support for its U.S. counterpart. A detailed review of these rules is outside the scope of this paper.⁶

1. Article XXI(6) - Canadian Donors who have U.S.-Source Income

Under the Act, a Canadian donor who has made a donation to a qualified donee may claim a charitable credit (in the case of an individual taxpayer) or deduction (in the case of a corporation) for the donation made. Subsection 149.1(1) of the Act provides that qualified donees are organizations that can issue official donation receipts to individuals and corporations for gifts made to them under paragraphs 110.1(1)(a) and (b) and 118.1(1). They consist of registered charities, registered Canadian amateur athletic associations, certain low-cost housing corporations for the aged, municipalities, provincial and federal governments, the United Nations and its agencies, prescribed universities outside Canada, charities outside Canada to which the federal government has made a gift in the past year, and registered national arts service organizations. In February 2004, it was proposed to amend sections 110.1 and 118.1 of the Act by including municipal or public bodies performing a function of government in Canada. This proposed amendment has been brought forth and is now included in the proposed amendments contained in Bill C-10 introduced in

⁶ For a review of some of the issues involved in relation to Canadian registered charities conducting foreign activities and providing support to foreign endeavours, see for example Robert B. Hayhoe, "A Critical Description of the Canadian Tax Treatment of Cross-Border Charitable Giving and Activities," (2001), vol. 49, no. 2 *Canadian Tax Journal*, 320-337 ("Hayhoe 2001") and Robert B. Hayhoe, "Cross-Border Operations by Canadian Registered Charities" in "International Tax Planning," (2004), vol. 52, no. 3 *Canadian Tax Journal*, 941-967 ("Hayhoe 2004").

Parliament on October 29, 2007.⁷ Therefore, U.S. charities are not qualified donees and therefore donations made to U.S. charities are not eligible for such tax relief.

However, this general rule does not apply to donations made to U.S. charities made within the parameters of Article XXI(6) of the Treaty. Pursuant to Article XXI(6) of the Treaty, where a U.S. charity receives a charitable donation from a Canadian donor, the Canadian donor may claim a charitable credit (in the case of an individual taxpayer) or deduction (in the case of a corporation) for the donation made to the U.S. charity. In this regard, Article XXI(6) of the Treaty provides as follows:

6. For the purposes of Canadian taxation, gifts by a resident of Canada to an organization that is a resident of the United States, that is generally exempt from United States tax and that could qualify in Canada as a registered charity if it were a resident of Canada and created or established in Canada, shall be treated as gifts to a registered charity; however, no relief from taxation shall be available in any taxation year with respect to such gifts (other than such gifts to a college or university at which the resident or a member of the resident's family is or was enrolled) to the extent that such relief would exceed the amount of relief that would be available under the Income Tax Act if the only income of the resident for that year were the resident's income arising in the United States. The preceding sentence shall not be interpreted to allow in any taxation year relief from taxation for gifts to registered charities in excess of the amount of relief allowed under the percentage limitations of the laws of Canada in respect of relief for gifts to registered charities.

⁷ On October 29, 2007, the former Bill C-33 to amend the *Income Tax Act* was re-introduced in Parliament as Bill C-10, *Income Tax Amendments Act, 2006*. The former Bill C-33 was introduced in November 2006, containing a package of proposed amendments to the *Income Tax Act* that were first introduced by Finance on December 20, 2002. A number of the proposed changes will impact the operations of registered charities in Canada in a substantial way, including the definition of “gift,” split-receipting, designation of charitable organizations and public foundations, revocation of charitable registrations, etc. These amendments undergone various incarnations on December 5, 2003, February 27, 2004 and July 18, 2005, and were finally introduced as Bill C-33 in November 2006. C-33 passed third reading in the House of Commons on June 15, 2007 and first reading in the Senate on June 18, 2007. Since Parliament was prorogued in September 2007, Bill C-33 died on the Order Paper. Bill C-10 has now received three readings in the House of Commons on that October 29, 2007 and received second reading in the Senate on December 4, 2007. The text of Bill C-10 is available at <http://www.parl.gc.ca/LEGISINFO/index.asp?Language=E&Chamber=N&StartList=A&EndList=Z&Session=15&Type=0&Scope=I&query=5296&List=toc-1>.

In order to benefit from this provision, the U.S. charity must meet a number of requirements. It must be resident in the U.S. It must be generally exempt from U.S. tax, It must also be able to qualify in Canada as a registered charity if it were a resident in Canada and created or established in Canada. Further, the benefit of Article XXI(6) is restricted to the Canadian donor's U.S.-source income. While this provision may be helpful to U.S. charities that receive occasional gifts from Canadian donors, the benefit of this provision is fairly limited for those U.S. charities seeking broad base support from the public in Canada, most of whom would not have much or any U.S.-source income.

In order to take the benefit under Article XXI(6), the U.S. charity must meet a number of criteria, *i.e.*, the donation must be a "gift," the donation credit is only limited to the Canadian donor's U.S.-source income, the U.S. charity must be resident in the U.S., it must generally be exempt from U.S. tax, and it could qualify in Canada as a registered charity if it were a resident in Canada and created or established in Canada.

Similarly, in the U.S., charitable contributions made directly to organizations not created or organized in the U.S., a state or territory, the District of Columbia, or a possession of the U.S. do not provide donors with the benefit of tax deductibility.⁸ However, this general rule does not apply to contributions made to Canadian charities within the parameters of Article XXI(5) of the Treaty. In this regard, U.S. donors who make charitable donations to Canadian charities are also entitled to similar relief with respect to the donors' Canadian-source income under Article XXI(5) of the Treaty, which provides as follows:

⁸ Code § 170(c)(2)(A). Donations by U.S. donors are only tax deductible if the donations are made to entities organized in the U.S. This is often the reason why entities established outside of the U.S. who want to solicit donations in the U.S. may want to establish parallel entities in the U.S. and obtain registration as tax-exempt organizations under Code § 501(c)(3).

5. For the purposes of United States taxation, contributions by a citizen or resident of the United States to an organization which is resident in Canada, which is generally exempt from Canadian tax and which could qualify in the United States to receive deductible contributions if it were resident in the United States shall be treated as charitable contributions; however, such contributions (other than such contributions to a college or university at which the citizen or resident or a member of his family is or was enrolled) shall not be deductible in any taxable year to the extent that they exceed an amount determined by applying the percentage limitations of the laws of the United States in respect of the deductibility of charitable contributions to the income of such citizen or resident arising in Canada. The preceding sentence shall not be interpreted to allow in any taxable year deductions for charitable contributions in excess of the amount allowed under the percentage limitations of the laws of the United States in respect of the deductibility of charitable contributions. For the purposes of this paragraph, a company that is a resident of Canada and that is taxable in the United States as if it were a resident of the United States shall be deemed to be a resident of the United States.

Each of the criteria set out in Article XXI(6) is reviewed in this section of the paper below.

Comparison of the application of Article XXI(6) will be made to the application of Article XXI(5) as well.

a) Transfer of gifts

Article XXI(6) applies to “gifts” made to U.S. charities. The word “gift” is not defined in the Treaty. Article III(2) of the Treaty provides that unless the context otherwise requires, any term not defined in the Treaty has the meaning under the laws of the country concerning the taxes to which the Treaty applies. Section 3 of the *Income Tax Convention Interpretation Act*⁹ provides that any terms not defined or fully defined in a treaty or is to be defined by reference to the laws of Canada, that term has, except to the extent that the context otherwise requires, the meaning it has for the purpose of

⁹ R.S.C. 1985, c.14.

the Act, as amended from time to time, and not the meaning it had for the purposes of the Act on the date the treaty was entered into or given the force of law.¹⁰

As such, the meaning of the word “gift” would be in accordance with the law of Canada at the time when a Canadian donor wishes to take advantage of Article XXI(6). The Act does not contain a definition of “gift.” Courts therefore apply the common law or civil law definition of the term. A gift at common law requires three elements, namely an intention to donate, acceptance of the gift and a sufficient act of delivery.¹¹ The court in *Friedberg v. The Queen* defined a gift to be “a voluntary transfer of property owned by a donor to a donee, in return for which no benefit or consideration flows to the donor.”¹² This definition has been adopted by Canada Revenue Agency (“CRA”).¹³

Recent proposed amendments to the Act would allow a donor to receive a donation tax receipt even in situations where the donor or someone else receives a limited advantage as a result of the gift, provided that the value of the property donated by the donor exceeds the amount of advantage received by the donor.¹⁴ This is referred to as “split-receipting” and is contained in Bill C-10 which was introduced on October 29, 2007.¹⁵ As explained above, these changes were first introduced by the Department of Finance on December 20, 2002, and were revised a number of times. The last round of revisions were released in November 2006 and introduced as Bill C-33. Since Parliament was prorogued in September 2007, Bill C-33 died on the Order Paper.

¹⁰ Jinyan Li, Arthur Cockfield, J. Scott Wilkie, *International Taxation in Canada* (Toronto: LexisNexis, 2006) at 39.

¹¹ Timothy G. Youdan, “Charitable Gifts and Pledges: Some General Comments,” paper presented at the Seventh Annual Estates and Trusts Law Summit, Law Society of Upper Canada, December 1 and 2, 2004.

¹² 89 D.T.C. 5115; [1989] 1 C.T.C. 274 (F.C.T.D.), var'd. 92 D.T.C. 6031 at 6032; [1992] 1 C.T.C. 1 (F.C.A.).

Although these proposed changes have not been enacted, the British Columbia Supreme Court in *Richert v. Stewards' Charitable Foundation*¹⁶ upheld compliance with the split-receipting rules, in spite of the fact that these rules have yet to be enacted into law. The appeal to the British Columbia Court of Appeal in January 2006 was dismissed.¹⁷ This paper is not intended to review and comment on the detailed proposed rules.¹⁸ However, the following is a brief summary of the applicable rules.¹⁹

- Voluntariness - The gift must be donated voluntarily by the donor.
- Eligible amount of gift - The value shown on the donation receipt would need to reflect the difference between the fair market value of the gift and the amount of the advantage. This receipted amount, which is to be shown on the receipt, is now known as the “eligible amount” of the gift. As such, in order to ascertain the value of the eligible amount of the gift,

¹³ Canada Revenue Agency, *Interpretation Bulletin* IT-110R3, “Gifts and Official Donation Receipts,” June 20, 1997. It indicates that a “gift” is a voluntary transfer of property without valuable consideration. Generally a gift is made if all three of the conditions listed below are satisfied: (a) some property—usually cash—is transferred by a donor to a registered charity; (b) the transfer is voluntary; and (c) the transfer is made without expectation of return. No benefit of any kind may be provided to the donor or to anyone designated by the donor, except where the benefit is of nominal value.

¹⁴ Proposed subsections 248(30) to (33) of the Act.

¹⁵ *Supra* note 7.

¹⁶ [2005] B.C.J. No. 279. See Suzanne E. White and Terrance S. Carter, “B.C. Court Upholds CRA Guidelines on Split-Receipting,” *Charity Law Bulletin* No. 68, April 7, 2005 (online: www.charitylaw.ca).

¹⁷ 2006 B.C.C.A. 9. In this regard, CRA’s *Registered Charities Newsletter* No. 17, Winter 2004, specifically indicates that the proposed guidelines in *Income Tax Technical News* No. 26 “can be relied on now, despite the fact that the proposed legislation is not yet law.”

¹⁸ For a more detailed review, see Theresa L.M. Man and Terrance S. Charter, “Bill C-33 - Proposed Amendments to the Income Tax Act affecting Charities,” *Charity Law Bulletin* No. 104, December 5, 2006; Theresa L.M. Man, “Tax Shelters and Charitable Donations – a Miss-Match” July 4, 2006 (online: www.charitylaw.ca); Theresa L.M. Man, “July 18, 2005 Draft Amendments to the Income Tax Act Affecting Charities: Part I – Definition of Gift & Split-Receipting,” *Charity Law Bulletin* No. 76, September 8, 2005; and M.E. Hoffstein, Theresa L. M. Man and Laura E. West, “When is an Advantage Not an Advantage—Issues Arising from the Proposed Split Receipting Regime,” paper presented to the Canadian Bar Association/Ontario Bar Association 4th National Symposium on Charity Law, May 11, 2006 (online: www.charitylaw.ca).

¹⁹ Given these proposed changes to the Act, CRA released *Income Tax Technical News* No. 26 on December 24, 2002 that sets out a list of guidelines on split-receipting and explains how to determine the eligible amount in situations where the donor received a benefit. See Theresa L.M. Man and Terrance S. Carter, “New CCRA Guidelines on Split-Receipting,” *Charity Law Bulletin* No. 23, July 31, 2003 (online: www.charitylaw.ca).

not only is the charity required to determine the fair market value of the property, the charity is also required to determine the amount of any advantage provided to the donor by obtaining a qualified independent valuation of the advantage where appropriate. Where the amount of the advantage is unascertainable, then no donation tax receipt could be issued.

- Advantage - The “amount of advantage” is very broadly defined, and includes the value of any “property, service, compensation or other benefit” that (1) the donor, (2) another person who does not deal at arm’s length with the donor, or (3) another person who does not deal at arm’s length with the donor and holds, directly or indirectly, an interest the donor has received or is entitled to receive (either immediately or in the future) that is in (i) consideration of; (ii) gratitude of; or (iii) any other way related to the gift.
- Intention to donate - The donor must have a clear intention to donate the property to the charity. If the amount of the advantage does not exceed 80% of the fair market value of the donated property, then the fact that the donor obtained an advantage from the donee charity will not necessarily disqualify the transfer from being qualified as a gift. If, however, the amount of an advantage exceeds 80% of the fair market value of the transferred property, then the donor will have the onus to prove to CRA that the donor has the intention to donate the property.
- *De Minimis* Rule - Where the amount of complementary advantage received by the donor is of insignificant value, CRA is prepared to accept an administrative *de minimis* threshold for the value of the benefit that is equal to the lesser of 10% of the value of the donated property and \$75. In such circumstances, the value of the advantage would be ignored and the eligible

amount of the gift would be equal to the fair market value of the property, without the need to deduct the value of the advantage. However, this *de minimis* threshold would not apply to cash or near cash advantages, such as redeemable gift certificates, vouchers, coupons.

- Deeming of fair market value - Under some situations, the fair market value of the property donated would be “deemed” to be the lesser of (i) the “fair market value of the property and (ii) the cost (or the adjusted cost base in the case of capital property) of the property to the donor immediately before the gift is made.

Canadian donors would need to ensure that the donation credit/deduction claimed in their income tax return for gifts made to U.S. charities would comply with these split-receipting requirements.

Similarly, the word “contribution” in Article XXI(5) is not defined in the Treaty. As explained above, pursuant to Article III(2) of the Treaty, for purposes of Article XXI(5), that which would constitute a “contribution” would be governed according to U.S. law, not Canadian law. In order to constitute a “gift,” it must involve a transfer of money or property with no expectation of any benefit in return. In the case of *Commissioner v. Duberstein*²⁰, the U.S. Supreme Court discussed the meaning of the term “gift” in Section 102 of the Code and noted that “[a] gift in the statutory sense ... proceeds from a detached and disinterested generosity, ... out of affection, respect, admiration, charity or like impulses” and that “in this regard, the most critical consideration ... is the transferor’s ‘intention.’” Revenue Ruling 83-104,²¹ provides that “a contribution for purpose of section 170 of the Code is a voluntary transfer of money or property that is made with no expectation of procuring a financial benefit commensurate with the amount of the transfer.”

In *Hernandez v. Commissioner*,²² the U.S. Supreme Court denied the deductibility of fees paid to the Church of Scientology for auditing and training sessions. The court stated that the “legislative history of the ‘contribution of gift’ limitation ... reveals that Congress intended to differentiate between unrequited payments to qualified recipients and payments made to such recipients in return for goods or services.” The court continued to note that only the former was deductible. However, where payments were made as part of a quintessential quid pro quo exchange in return for an identified benefit for the money received, such payments are not deductible. Where a contribution is made to a charity partly in consideration for goods or services, the regulations of the Code provide a two-part test for deductibility. The test is based on the case of *United States v. American Bar Endowment*.²³ In that situation, the donor must intend to make, and in fact make, a payment in excess of the fair market value of the goods and services received. The deductibility of the contribution would be limited to the difference between the payment made by the donor and the value of the goods or services received.²⁴ Property and services of insubstantial value may be disregarded.²⁵

b) Limit of donation

The income tax relief available pursuant to Article XXI(6) is only applicable to the Canadian donor’s U.S.-source income up to the usual limits for charitable donations under the Act.²⁶

²⁰ 363 U.S. 278, 285 (1960). See also *Allen v. U.S.*, 541 F.2d 786 (9th Cir. 1976).

²¹ 1983-2 C.B. 46.

²² 490 U.S. 680 (1989).

²³ 477 U.S. 105 (1986).

²⁴ U.S. *Income Tax Regulations* § 1.170A-1(h)(1), (2).

²⁵ U.S. *Income Tax Regulations* § 1.170A-1(h)(3), 1.170A-13(f)(8), (9). Rev. Proc. 90-12, 1990-1 C.B. 471. See also Revenue Ruling 76-246. 1967-2 C.B. 104.

²⁶ Similarly, under paragraph 5 of Article XXI of the Treaty, a U.S. donor can make a tax-deductible donation from Canadian-source income for donations made to a Canadian registered charity.

In Canada, when an individual makes a donation to a qualified donee, the individual is permitted to claim a non-refundable tax credit²⁷ pursuant to the rules set out in section 118.1 of the Act when calculating the tax payable. Pursuant to subsection 118.1(3) of the Act, the credit is currently 15.5%²⁸ of the first \$200 eligible amount of donations²⁹ made in the taxation year, and 29%³⁰ for eligible amounts of donations made over \$200 in the taxation year. Unused donation credits in a year may be carried forward for five years if they are not claimed in the year the donations are made.³¹ Generally, the maximum amount of donations that may be claimed in a year is 75% of net income, plus 25% of certain taxable capital gains, 25% of any capital cost recapture.³²

It is important to note that the exemption for a charitable bequest under Article XXIX B(1) of the Treaty³³ only applies to gifts in relation to U.S. estate tax purposes and is particularly aimed at providing a relief for Canadian residents who are not U.S. citizens and who bequeath property to Canadian registered charities. Where a deceased person, who was a Canadian resident and not a U.S. citizen immediately before death, bequeaths property to a U.S. tax-exempt charity, Article XXI(6) of the Treaty would apply and Article XXIX B(1) of the Treaty would not apply. If the deceased

²⁷ The change from donation deduction to donation credit for individuals was enacted in 1988 as part of the overall move to a tax credit regime. *Income Tax Act*, S.C. 1988, c. 55, s. 78, enacted following the 18 June 1987 White Paper on tax reform. See David G. Duff, “Charitable Contributions and the Personal Income Tax: Evaluating the Canadian Credit,” in *Between State and Market: Essays on Charities Law and Policy in Canada* (Montreal: McGill-Queen’s University Press, 2001) 407-56 [“Duff 2001”]

²⁸ “Appropriate percentage” is defined in subsection 248(1). The applicable percentage is the lowest percentage set out in paragraph 117(2)(a). Paragraph 117(2)(a) has been amended by the 2006 federal budget, *An Act to implement certain provisions of the budget tabled in Parliament on May 2, 2006*, S.C. 2006, c. 4, enacted on June 22, 2006, so that the tax rate is 15% for 2005, 15.25% for 2006, and 15.5% for 2007 and after.

²⁹ “Eligible amount” of a gift is defined in proposed subsection 248(31) to be the amount by which the gift exceeds the amount of advantage received in respect of the gift. The proposed definition applies to gifts made after December 20, 2002. This proposed change is included in the proposed Bill C-10 referred to *supra* note 7.

³⁰ This is the highest marginal federal rate of tax set out in paragraph 117(2)(d).

³¹ See the opening wording of the definition for “total charitable gifts” in subsection 118.1(1).

³² See paragraph (iii) in the definition for “total gifts” in subsection 118.1(1).

³³ This was inserted by Article 19 of the Third Protocol in 1995.

has no U.S. source income in the year of death or in the year immediately preceding the year of death, no donation credit will be allowed under section 118.1 of the Act.³⁴

In relation to gifts made by Canadian corporations, pursuant paragraph 110.1(1)(a) of the Act, a corporation may deduct the eligible amount of gifts made to qualified donees in the year or in the preceding five years. In general, a corporation is entitled to a tax deduction from its taxable income, up to a maximum of 75% of its net income, plus 25% of certain taxable capital gains, and 25% of any capital cost recapture.³⁵ Again, the tax relief of gifts made to U.S. charities only applies to the Canadian corporate donor's U.S.-source income up to the usual limits for charitable donations under the Act.³⁶

However, corporate giving may involve different forms of support. Where a contribution by a corporation is a "sponsorship fee," which is not a defined term in the Act, CRA takes the view that they are "not gifts because the sponsor receives something in exchange" and "they are usually paid

³⁴ Canada Revenue Agency, document number 9629805, December 19, 1996. The purpose of Article XXIX B is to better coordinate the operation of the death tax regimes of the U.S. and Canada. Such coordination is necessary because the U.S. imposes an estate tax, while Canada applies an income tax on capital gains deemed realized at death rather than an estate tax. Article XXIX B(1) provides that a contracting state shall accord the same death tax treatment to a bequest by an individual resident in one of the contracting states to a qualifying exempt organization (one that meets the requirements in Article XXI(1) of the Treaty) resident in the other contracting state as it would have been accorded if the organization has been resident in the contracting state of which the testator is a resident. Pursuant to the estate tax provisions under the Code, a U.S. citizen or resident is able to deduct gifts to any public charity organized either in the U.S. or elsewhere. Also under the Code, a Canadian resident who is *not* a U.S. citizen and who bequeaths property to U.S. public charities is allowed a deduction for U.S. estate tax purposes. Under Article XXIX B of the Treaty for U.S. estate tax purposes, a resident of Canada who was not a U.S. citizen immediately before death and who bequeaths property to a Canadian registered charity will be treated as if he or she had bequeathed property to a charity organized in the U.S. Consequently, the amount of such a bequest will be allowed as a deduction for U.S. estate tax purposes under the Code provided that the property so bequeathed is part of the assets that would be included in the gross estate situated in the U.S. of the deceased person. Since there is no estate tax in Canada, Article XXIX B(1) of the Treaty would have no application in Canada. In Canada, the deductibility of charitable gifts to U.S. exempt organizations continues to be governed by Article XXI(6) of the Treaty and the provisions of the Act.

³⁵ For a review of the treatment of corporate donations and other forms of corporate giving under the Act, see Theresa L.M. Man, "Corporate Giving: a Tax Perspective" September 18, 2006 (online: www.charitylaw.ca).

³⁶ See Canada Revenue Agency, document number 9816063, June 17, 1999.

to support a charity event in return for advertising or some other consideration.”³⁷ As pointed out in an employee speech by a senior official of CRA,³⁸ the word “sponsorship” is poorly defined and it could take on different meanings.³⁹ CRA pointed out that there is some confusion as to the proper use of the term, and some question on the part of recipient charities as to whether they should be issuing receipts or not, in light of the proposed arrangement between them and the sponsor. CRA further pointed out that the *Concise Oxford Dictionary* gives several definitions of “sponsorship,” notably, “a sponsor is one who makes himself responsible for another, or a person who subscribes to a charity in return for a specified activity by another (*e.g.*, walk-a-thons)” or “an advertiser who pays for a programme into which advertisements of his wares are introduced.”⁴⁰ Where payment is made as a sponsorship fee, the deduction of sponsorship fees as a business expense under section 18 of the Act is not subject to the limits imposed for charitable donations, provided that the deduction is made in respect of an outlay or expense that was reasonable in the circumstance required under section 67 of the Act. In addition, a charitable tax deduction can be carried forward for a period of five years, while sponsorship fees must usually be deducted within the fiscal year in which it was made.⁴¹

Similarly, for purposes of Article XXI(5) in relation to Canadian charities receiving donations from U.S. donors, the income tax relief is only applicable to the U.S. donor’s Canadian-source income up to the usual limits for charitable donations under the Code. Furthermore, section 170(b) of the Code provides a maximum limit to the deductibility of charitable contributions made by a taxpayer in a year, based on a percentage of the taxpayer’s contribution base. “Contribution base” means

³⁷ Canada Revenue Agency, *Summary Policy* CSP-S13, “Sponsorship,” September 3, 2003.

³⁸ Canada Revenue Agency, *Employee Speech* CES-012, “CCRA Update,” October 3, 2000.

³⁹ *Ibid.* at para. 51.

⁴⁰ *Ibid.* at para. 52.

adjusted gross income computed without any regard to any net operating loss carryback to the taxable year under section 172.⁴² In general, contributions by individuals to public charities and certain private foundations may be deducted up to 50% of adjusted gross income computed without regard to net operating loss carrybacks.⁴³ Contributions to certain other private foundations and other organizations are limited to 30% of adjusted gross income (computed without regard to net operating loss carrybacks).⁴⁴ Contributions by corporations are generally limited to 10% of the corporations' taxable income.⁴⁵ For both individuals and corporations, charitable contributions not deductible in the current year may be carried forward five years.⁴⁶

However, the claim by a Canadian donor for charitable deduction pursuant to Article XXI(6) of the Treaty will not be restricted to the donor's U.S.-source income (although the 20% limitation will still apply) if the recipient U.S. charity is a U.S. college or university at which the donor, or a member of the donor's family, is or was enrolled.⁴⁷ Paragraph 2 of a letter between the U.S. and Canada dated September 26, 1980⁴⁸ clarified that the term "family" means an individual's "brothers and sisters (whether by whole or half-blood, or by adoption), spouse, ancestors, lineal descendants and adopted descendants." This would include donations made by students, alumni and their family

⁴¹ See Theresa L.M. Man, "Corporate Giving: a Tax Perspective," *supra* note 35.

⁴² Code § 170(b)(1)(F).

⁴³ Code § 170(b)(1).

⁴⁴ *Ibid.*

⁴⁵ Code § 170(b)(2).

⁴⁶ Code § 170(d).

⁴⁷ This tax relief is in addition to the tuition fees for a student in full-time attendance at a university outside Canada for a course, of at least 13 consecutive weeks in duration, leading to a degree under paragraph 118.1(5)(b) of the Act and tuition fees (if they total more than \$100) for courses at a post-secondary school level paid to a university, college or other educational institution in the United States to which a student living near the Canada-United States border commutes pursuant to paragraph 118.1(5)(c) of the Act. See also Canada Revenue Agency, *Interpretation Bulletin* IT-516R2, "Tuition Tax Credit," December 9, 1996.

⁴⁸ Letter between Canada and the United States, September 26, 1980 (CCH). The letter confirms "certain understandings" between the two governments in relation to the Treaty with regard to the French term "société," exemption organizations, and the taxation of Canadian multinationals in the United States.

members. In this case, the universities do not need to be prescribed pursuant to Regulation 3503 and named in Schedule VIII to the Act, which is reviewed on page 35 below. Pursuant to Article XXI(5), similar reciprocal relief is applicable to donations by a U.S. donor from his/her Canadian-source income to a Canadian charity that is a Canadian college or university at which the donor, or a member of the donor's family, is or was enrolled.

For Canadian donors to take benefit of Article XXI(6), CRA has indicated that for tax purposes, the Canadian donor must obtain a receipt from the qualified U.S. charity.⁴⁹ It further indicates that depending on how the donor files his or her income tax return, the donor must either submit the receipt with the return or keep it for possible review at a later date. This is in spite of what is required under the Internal Revenue Service (“IRS”) regulations for U.S. charities, whereby acknowledgment letters or receipts may not be sent to donors. In this regard, in order for U.S. donors to claim deductions pursuant to Article XXI(5), donation receipts are not required to be issued by the Canadian recipient charities. In the U.S., receipts are not always provided by U.S. charities. For gifts made prior to January 1, 2007, a donor may claim deduction for donations less than US\$250 without any receipt or acknowledgment from the U.S. charity if the donor can provide bank or other records evidencing the donation. For donations \$250 or more, an acknowledgment from the U.S. charity is required. Therefore, the U.S. charity need not send any receipt or written acknowledgment to the donor for donations of less than \$250. As a result of Section 1217 of the *Pension Protection Act* of 2006, for gifts made on or after January 1, 2007, a donor cannot deduct a cash contribution, regardless of the amount, unless the donor retains a bank record evidencing the donation or a written acknowledgment from the U.S. charity showing the name of the charity, as

⁴⁹ Canada Revenue Agency, *Registered Charities Newsletter* No. 6-1, Autumn 1996 – Special Release.

well as the date and amount of the contribution. There is no required form for the acknowledgement. Therefore, a U.S. charity need not provide any receipt or acknowledgment if the donor can provide other records to evidence the donations made.⁵⁰

c) Donor of gifts

Article XXI(6) applies to charitable donations made by residents of Canada. There may be an issue of whether Article XXI(6) applies only to gifts made by Canadian donors, or whether this provision also applies to gifts by Canadian registered charities. Although it would appear that U.S. charities may rely on Article XXI(5) of the Treaty in transferring contributions to Canadian registered charities,⁵¹ there does not appear to be a reciprocal application of Article XXI(6) with respect to transfer of gifts by Canadian registered charities to U.S. charities. In this regard, in the U.S., tax relief pursuant to Article XXI(5) of the Treaty is available to charitable contributions made by U.S. citizens and residents. In addition to individuals and corporations in the U.S., U.S. charities may also rely on Article XXI(5) of the Treaty in transferring contributions to Canadian registered charities. In this regard, U.S. private foundations may make grants to Canadian registered charities free of the expenditure responsibility that U.S. law usually imposes for such grants and without the delay to obtain affidavit or legal opinions regarding the donee's public charity status.⁵²

⁵⁰ Code § 170(f)(8), and U.S. *Income Tax Regulations* § 1.170A-13(f). See also IRS Publication 1771, "Charitable Contributions" (July 2005) and Publication 526, "Charitable Contributions" (2006) on www.irs.gov. See also "Provisions of Interest to Charitable Organizations and their Donors in H.R. 4, the Pension Protection Act of 2006" Simpson Thatcher & Bartlett LLP, August 24, 2006 (online: <http://www.stblaw.com>).

⁵¹ Jane Peebles, *supra* note 2. The author of this article indicates at page 21 that "U.S. private foundations may make grants to Canadian 'registered charities' free of the cumbersome expenditure responsibility that U.S. law usually imposes for such grants and without the delay to obtain affidavit or legal opinions regarding the donee's public charity status."

⁵² Peebles, *supra* note 2 at 21.

While an argument could be made that Article XXI(6) allows a Canadian registered charity to transfer a gift to a U.S. charity to the extent of the Canadian charity's U.S.-source income,⁵³ CRA does not accept such an argument. In this regard, CRA is of the view that Article XXI(6) merely treats a gift to a U.S. charity as a gift to a Canadian registered charity, and it does not deem U.S. charities to be Canadian registered charities or "qualified donees."⁵⁴ CRA also indicated that if U.S. charities were treated as qualified donees for the purposes of the Act as a result of the application of Article XXI(6), greater relief than what was intended would have been provided to them.⁵⁵ Therefore, CRA implies that Article XXI(6) only applies to gifts by individual and corporate donors, but not to gifts made by registered charities. Although not explicitly stated by CRA, it would appear that CRA's rationale is based upon the assumption that the context of Article XXI(6) is with respect to providing tax relief to donations made by Canadian taxpayers from their taxable income. Since the income of Canadian registered charities is not taxable under the Act and the disbursement of funds by Canadian registered charities is governed by a different set of rules in the Act, perhaps this is the reason why Article XXI(6) does not apply to gifts made by Canadian registered charities to U.S. charities. However, this rationale would be inconsistent with the practice of U.S. charities being able to rely on Article XXI(5) in making contributions to Canadian charities. This

⁵³ Hayhoe 2004, *supra* note 6 at 948-949.

⁵⁴ Canada Revenue Agency, document number 9428085, December 22, 1994; document number 9728355, February 27, 1998; Revenue Agency, *Registered Charities Newsletter* No. 6-1, *supra* note 49.

⁵⁵ *Ibid.*

inconsistency will need to be clarified, perhaps through the assistance of the Minister of National Revenue as the Canadian competent authority pursuant to Article XXIV of the Treaty.⁵⁶

d) Charities resident in the U.S.

In order for a gift to a U.S. charity to qualify for the benefits offered by Article XXI(6) of the Treaty, the U.S. charity must be a “resident of” the U.S. Similarly, in order for a donation by a U.S. donor to a Canadian charity to claim treaty benefits under Article XXI(5) of the Treaty, it must be a resident of Canada. Article IV(1) of the Treaty defines the term “resident of a contracting state” to mean any person who, under the laws of that state, is “liable to tax therein by reason of that person’s domicile, residence, citizenship, place of management, place of incorporation, or any other criterion of a similar nature,” including, for U.S. purposes, an election under the Code to be treated as a U.S. resident.⁵⁷ Article IV of the Treaty was amended by the Third Protocol in 1995⁵⁸ to provide that the term “resident” is “understood to include ... a not-for-profit organization that was constituted in that State and is, by reason of its nature, as such, generally exempt from income taxation in that State.”

⁵⁶ Canada Revenue Agency, *Information Circular* IC71-17R5, “Guidance on Competent Authority Assistance under Canada’s Tax Conventions,” January 1, 2005. See also Canada Revenue Agency and Internal Revenue Services, *Memorandum of Understanding Between the Competent Authorities of Canada and the United States Regarding the Mutual Agreement Procedure*, June 3, 2005; Greg Noble and Robert Turner, “Competent Authority Update,” *Report of Proceedings of Fifty-Seventh Tax Conference, 2005 Tax Conference* (Toronto: Canadian Tax Foundation, 2006), 29:1-23; Claude Lemelin and Regina Deanehan, “The Competent Authority Process: A Canadian and US Comparative Analysis” in “International Tax Planning,” (1998), vol. 46, no. 3 *Canadian Tax Journal*, 657-677.

⁵⁷ For a discussion of the application of Article IV to taxable entities, see *The Queen v. Crown Forest Industries Limited et al.*, 95 D.T.C. 5389 (S.C.C.), David A. Ward, John F. Avery Jones, Luc de Broe, Micheline van de Wiele, Maarten J. Ellis, Kees van Raad, Raoul Lenz, Henri Torrione, Toshio Miyatake, Sidney I. Roberts, Sanford Goldberg, Jakob Stobl, Jurgen Killius, Victor Uckmar, Federico Giuliane and Guglielmo Maisto, “A Resident of a Contracting State for Tax Treaty Purposes: A Case Comment on Crown Forest Industries,” (1996), vol. 44, no. 2 *Canadian Tax Journal*, 408-424; and Canada Revenue Agency, document number 9524971, November 3, 1997.

⁵⁸ Third Protocol signed on March 17, 1995 and enacted in Canada by S.C. 1995, c. 34, Royal Assent November 8, 1995.

i) “Liable to tax”

Article IV of the Treaty requires that a resident must be “liable to tax” in the jurisdiction in which the person is a resident. The issue that arises from this requirement is whether a U.S. charity, being generally exempt from tax in the U.S., would be considered a resident of the U.S. for purposes of Article IV. Similarly, the question is whether a Canadian charity would be considered as resident of Canada for purpose of Article IV. The technical explanation of the Treaty released in 1984⁵⁹ indicates that since Article XXI deals with entities that are not normally taxable, the test of “resident” for purpose of Article XXI is “intended to be similar - but cannot be identical - to the one outlined in paragraph 1 of Article IV” of the Treaty.

From the Canadian perspective, CRA acknowledged that it is possible for a tax-exempt organization to be resident in a contracting state for purposes of Article XXI, notwithstanding that the organization may not be a resident of a contracting state within the meaning of Article IV due to the fact that it is not liable to tax.⁶⁰ CRA recently clarified the residency test as it relates to tax-exempt entities in CRA’s *Income Tax – Technical News* No. 35 released in 2007.⁶¹ CRA confirmed its position that to be considered “liable to tax,” a person must be subject to the most comprehensive form of taxation as exists in the relevant country. For Canada, this generally means full tax liability on worldwide income.⁶²

⁵⁹ United States of America, *Technical Explanation of the Convention*, April 26, 1984. The Canadian Department of Finance issued a news release on August 16, 1984 stating that the U.S. technical interpretation accurately reflects the understandings reached in the course of the negotiations of the Treaty.

⁶⁰ Canada Revenue Agency document number OC90_351_353, October 1, 1990.

⁶¹ Canada Revenue Agency, *Income Tax – Technical News* No. 35, February 26, 2007.

⁶² *The Queen v. Crown Forest Industries Limited et al.*, 95 D.T.C. 5389 (S.C.C.).

Prior to the release of the *Income Tax – Technical News* No. 35, it had been pointed out to CRA that in certain countries, the tax system generally taxes entities that have a particular attachment to that country on a worldwide income basis at a rate comparable to Canadian tax rates, but some of these entities are, according to special rules, either exempted from taxation or taxed at a very low rate. Previously, CRA’s position was that entities benefiting from such special regimes may not be subject to the most comprehensive form of taxation and therefore, would not be “liable to tax.” However, CRA had nonetheless considered such entities as “residents” under the treaties and granted them treaty benefits in the past.⁶³ As a result of concerns from tax professionals on this issue, CRA reviewed its position regarding the level of taxation a jurisdiction must levy on a person’s income before that person would be considered “liable to tax” under a tax treaty. CRA had recently completed its review and indicated in *Income Tax – Technical News* No. 35 that in general, to be considered “liable to tax” for the purposes of the residence article of Canada’s tax treaties, a person must generally be subject to the most comprehensive form of taxation as exists in the relevant country. However, CRA acknowledged that this does not necessarily mean that a person must pay tax to a particular jurisdiction. CRA recognized that there may be situations where a person’s worldwide income is subject to a contracting state’s full taxing jurisdiction but that state’s domestic law does not levy tax on a person's taxable income or taxes it at low rates. In these cases, CRA will generally accept that the person is a resident of the other contracting state unless the arrangement is abusive (e.g., treaty shopping where the person is in fact only a “resident of convenience”). CRA further indicated that the determination of residency for the purposes of a tax treaty is a question of fact, and each case will be decided on its own facts with an eye to the intention of the parties of the particular convention and the purpose of international tax treaties.

⁶³ *Supra* note 61.

ii) Constituted in the U.S.

Article IV(1)(b) of the Treaty provides that the term “resident” is “understood to include ... a not-for-profit organization that was constituted in that State and is, by reason of its nature, as such, generally exempt from income taxation in that State.” The technical explanation to the Third Protocol⁶⁴ clarifies that in order for a charity to be recognized as a resident of a contracting state, in addition to the charity being “generally exempt from income taxation” in the contracting state by reason of its nature, it must also be “constituted” in that state⁶⁵

In Canada, registered charities must resident in Canada that are either created or established in Canada.⁶⁶ The Act further deems a corporation incorporated in Canada after April 26, 1965 to be a resident in Canada for tax purposes, regardless of whether the corporation is managed or controlled within or outside of Canada.⁶⁷ Where a registered charity is constituted as a trust, its residency is determined by where the trustees reside. If a trust has more than one trustee, the residency of the trust is determined by where the majority of the trustees resides if they could make a decision by majority decision.⁶⁸

In relation to charities in the U.S., the technical explanation also indicates that “not-for-profit organizations” are organizations such as those listed in section 501(c) of the Code. While this is a

⁶⁴ United States of America, *Technical Explanation of the Convention*, March 17, 1995. The Canadian Department of Finance issued news release 95-048, June 13, 1995 stating that the U.S. technical interpretation accurately reflects the understandings reached in the course of the negotiations of the Third Protocol.

⁶⁵ This is consistent with the statutory place of incorporation test adopted by the Act. Paragraph 150(4)(a) of the Act deems a corporation to be a resident of Canada for tax purposes if it is incorporated in Canada at any time. See *supra* note 10 at 58. In this regard, Canadian registered charities are required to be resident in Canada, and, for this reason, entities not constituted in Canada do not qualify to be registered charities in Canada. See the definition for “registered charity” in subsection 248(1) of the Act and Canada Revenue Agency, *Information Letter*, CIL-1999-016, July 26, 1999.

⁶⁶ See definition for “registered charity” in subsection 248(1) of the Act.

⁶⁷ Paragraph 250(4)(a) of the Act.

⁶⁸ See also Canada Revenue Agency, *Interpretation Bulletin*, IT-447 “Residence of a Trust or Estate” May 30, 1980.

helpful clarification, it is important to note that entities organized outside of the U.S. are permitted to apply for tax-exempt status under section 501(c)(3) of the Code. However, this is only for the purpose of facilitating U.S. charities to make grants to foreign charities, not for the purpose of facilitating charitable donations by U.S. donors.⁶⁹ Donations by U.S. donors are usually only tax deductible if the donations are made to entities organized in the U.S.⁷⁰ As such, the mere fact that an entity is registered in the U.S. under section 501(c)(3) of the Code does not necessary imply that the entity is resident in the U.S. For example, a charity that is established in another country with which Canada does not have a treaty but has obtained recognition under 501(c)(3) of the Code in the U.S. would not be recognized as an entity that is “resident” in the U.S. for purpose of the Treaty even though it has been recognized under 501(c)(3) of the Code. As such, an independent determination will need to be made whether the particular 501(c)(3) tax-exempt entity in question is “constituted” in the U.S. in order to determine whether it is “resident” in the U.S.

e) U.S. charities that could qualify in Canada as a registered charity

To take the benefit of Article XXI(6) of the Treaty, a charitable gift must be made by a Canadian donor to a charity that is “generally exempt from U.S. tax that could qualify in Canada as a registered charity if it were a resident in Canada and created or established in Canada.” Therefore, there are two requirements. First, the recipient must be generally exempt from U.S. tax. Second, the recipient could qualify in Canada to receive deductible contributions if it were resident in Canada.

⁶⁹ See Kimberly S. Blanchard, “U.S. Taxation of Foreign Charities” (1993), vol. 8, no. 4 *Exempt Organizations Tax Review* 719-29, at 722 and 726; Jane Peebles, *supra* note 2 at 8 and 9.

⁷⁰ Section 170(c) of the Code. Donations by U.S. donors are only tax deductible if the donations are made to entities organized in the U.S. This is often the reason why entities established outside of the U.S. who want to solicit donations in the U.S. may want to establish parallel entities in the U.S. and obtain registration as tax-exempt organizations under section 501(c)(3) of the Code.

In this regard, CRA indicates that they “accept any organization that qualifies under section 501(c)(3) of the Code” will meet this test.⁷¹ This position of CRA is reflected in the recognition procedure reviewed in the next section of this paper.

On the other hand, in order to benefit from Article XI(5), entities listed in subsection 149(1) of the Act are exempt from paying taxes under Part I of the Act and thereby would meet the first requirement. One of these types of entities is registered charities in Canada. In order to qualify as a registered charity in Canada, it must be organized and operated exclusively for one or more heads of charitable purposes as recognized at common law by the courts, namely relief of poverty, advancement of education, advancement of religion, or other purposes beneficial to the community in a way the law regards as charitable.⁷² Therefore, this requirement could be met by a very broad array of organizations.

However, the broad array of organizations that meet the first requirement would be limited to those that qualify in the U.S. to receive deductible contributions if they were resident in the U.S. Under the Code, for a “charitable contribution” to be deductible, it must involve a transfer of money or property with no expectation of a return benefit, property made to or for the use of a qualified recipient as defined in section 170(c) of the Code, property or money is actually be paid to the recipient, and the deduction is within certain percentage limitations. Section 170(c) of the Code lists a number of qualified recipients in this regard, including the following:

⁷¹ Canada Revenue Agency, document number 9900795, April 21, 1999.

⁷² *Commissioners for Special Purposes of Income Tax v. Pemsel* [1891] A.C. 531. See also *Tudor on Charities*, 8th ed., Jean Warburton and Deborah Morris (London: Sweet & Maxwell, 1995) at 8; *Vancouver Society of Immigrant and Visible Minority Women v. Minister of National Revenue*, [1999] 1 S.C.R. 10; Canada Revenue Agency, *Summary Policy* CSP-C01, “Charitable Purposes,” October 25, 2002, and Canada Revenue Agency, *Guidelines* CPS-024, “Guidelines for Registering a Charity: Meeting the Public Benefit Test,” March 10, 2006, at para. 2.0.

- Section 170(c)(1) - A State, a possession of the United States, or any political subdivision of any of the foregoing, or the United States or the District of Columbia, but only if the contribution or gift is made for exclusively public purposes;
- Section 170(c)(2) - A corporation, trust, or community chest, fund, or foundation (a) created in the U.S., (b) organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes, or to foster national or international amateur sports competition (but only if no part of its activities involve the provision of athletic facilities or equipment), or for the prevention of cruelty to children or animals; (c) no part of the net earnings of which inures to the benefit of any private shareholder or individual; (d) does not engage in political activities; and (e) the contribution is to be used within the U.S. or any of its possessions exclusively for purposes specified in subparagraph (b) above;
- Section 170(c)(3) - A post or organization of war veterans, or an auxiliary unit or society of, or trust or foundation for, any such post or organization;
- Section 170(c)(4) - A domestic fraternal society, order, or association, operating under the lodge system, but only if such contribution or gift is to be used exclusively for religious, charitable, scientific, literary, or educational purposes, or for the prevention of cruelty to children or animals; and
- Section 170(c)(5) - Certain cemetery companies.

As such, in general, only those entities that are organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes, or to foster national or international amateur sports competition or for the prevention of cruelty to children or animals would meet both requirements. Similarly, the application of Article XXI(1) of the Treaty in relation to the exemption of income earned by a charity from income tax in the other contracting state is also restricted to “religious, scientific, literary, educational or charitable” organizations.

It is, therefore, interesting to note that U.S. charities that qualify for benefits under Article XXI(6) are much broader than the U.S. charities qualifying for Treaty benefits under Article XXI(5) and Article XXI(1). Article XXI(1) and Article XXI(5) in general are restricted to “religious, scientific, literary, educational or charitable” organizations, while the application of Article XXI(6) is not

restricted to these types of U.S. charities, but applies to all of the eight enumerated types of U.S. charities in section 501(c)(3) of the Code. Section 501(c)(3) of the Code provides as follow:

Corporations, and any community chest, fund or foundation, organized and operating exclusively for religious, charitable, scientific, testing for public safety, literary or educational purposes, or to foster national or international amateur sports competition (but only if no part of its activities involve the provision of athletic facilities or equipment), or for the prevention of cruelty to children or animals

Section 501(c)(3) of the Code provides income tax exemption for eight enumerated organizations. Only five of the eight enumerated categories are set out in Article XXI(1). The three enumerated categories that have not been included in Article XX(1) are testing for public safety, fostering national or international amateur sports competition (but only if no part of its activities involve the provision of athletic facilities or equipment), and preventing cruelty to children or animals.

Therefore, in situations where U.S. charities are seeking the benefits of Article XXI(1), it would appear only those five categories would be eligible for benefits under this Article. Perhaps this is the basis for U.S. charities seeking Treaty benefits under Article XXI(1) being required to submit an application to CRA, while Canadian charities seeking reciprocal Treaty benefits are not required to do so. The recognition process is reviewed in the next section of this paper below.

f) Recognition procedure under the Treaty

In a letter between the U.S. and Canada dated September 26, 1980 (the “Letter”),⁷³ it was agreed that the competent authority of each contracting state would review the procedures and requirements for an organization of the other contracting state in order to establish its status as a

⁷³ *Supra* note 48.

religious, scientific, literary, educational or charitable organization entitled to exemption under Article XXI(1) of the Treaty, or as an eligible recipient of charitable gifts or contributions referred to in Articles XXI(5) or XXI(6) of the Treaty. This would avoid duplicate applications by such an organization to the administering agencies of both contracting states. The Letter further provides that if a contracting state determines that the other contracting state maintains procedures and rules for qualification that are compatible with its procedures and rules, it is contemplated that the contracting state shall accept the certification of the administering agency of the other contracting state concerning such status for the purpose of making the necessary determinations under Articles XXI(1), XXI(5) and XXI(6).

IRS's Notice 99-47 "Guidance Relating to Article XXI of the United States-Canada Income Tax Treaty"⁷⁴ indicates that a mutual agreement has been entered into between Canada and the U.S. in order to implement the understanding confirmed in the Letter. The Notice indicates that under the terms of the mutual agreement, recognized religious, scientific, literary, educational or charitable organizations that are organized under the law of either the U.S. or Canada will automatically receive recognition or exemption without application in the other country. It has been noted that CRA has not publicized the fact that such a mutual agreement has been entered into and that its disclosure under the *Access to Information Act* has been refused on the basis of paragraph 13(1)(a) of that statute, which provides that "the head of a government institution shall refuse to disclose any record requested ... that contains information that was obtained in confidence from the government

⁷⁴ United States of America, *Internal Revenue Service*, Notice 99-47 "Guidance Relating to Article XXI of the United States-Canada Income Tax Convention," September 7, 1999. See also Paul Carezza, "Competent Authority Agreement?" (2002) Vol. 10, no. 10 *Canadian Tax Highlights*, 78; and Benoît Lacoste Bienvenue, "Charitable Organizations Investing into the United States" (2005) vol. 5, no. 3 *Tax for the Owner Manager*, 5-6.

of a foreign state or an institution thereof.”⁷⁵ As such, Canadian taxpayers and their advisors are left to rely on an IRS Notice to interpret the application of the mutual agreement.

U.S. charities must be recognized as exempt under section 501(c)(3) of the Code in order to qualify for exemption under Article XXI. In the context of Article XXI(6) of the Treaty, CRA indicates that for the purposes of U.S. charities receiving donations from Canadian donors, U.S. charities that qualify under section 501(c)(3) of the Code do not need to apply to CRA in Canada, but they may have to show proof that it qualifies under the Code as such.⁷⁶ CRA further indicates that if a receiving U.S. charity is not listed in IRS Publication 78, the Canadian donor should verify whether the organization qualifies under section 501(c)(3) of the Code by asking for a copy of the organization’s IRS determination letter or by contacting IRS to verify that organization’s status. CRA also indicates that this recognition of U.S. charities does not mean that they are “qualified donees” for purposes of the Act.⁷⁷

Although both the Notice and the Letter indicate that the automatic exemption recognition applies to Articles XXI(1), XXI(5) and XXI(6) of the Treaty, from CRA’s perspective, such an automatic recognition procedure is only available for U.S. charities seeking Treaty benefits under Article XXI(6) of the Treaty but not under Article XXI(1).⁷⁸ In order to seek benefit under Article XXI(1) of the Treaty, U.S. charities are required to submit an application to CRA’s International Tax Services Office. Such an application procedure is reviewed on page 57 below.

⁷⁵ Carenza, *supra* note 74.

⁷⁶ See Canada Revenue Agency, *Registered Charities Newsletter* No. 6-1, *supra* note 49. See also Canada Revenue Agency, document number 9900795, April 21, 1999.

⁷⁷ *Supra* note 49.

⁷⁸ See Carenza, *supra* note 74.

By contrast, Canadian charities wishing to seek benefits under both Articles XXI(1) and XXI(5) of the Treaty in the U.S. can automatically be recognized, without the need to make any application to the IRS. In this regard, the Notice indicates that it is a requirement of the mutual agreement that Canadian organizations must be recognized as Canadian registered charities, *i.e.*, as defined in section 248(1) of the Act, in order to obtain benefit under Article XXI(1). As such, Canadian registered charities will automatically be recognized as 501(c)(3) organizations and will not be required to file Form 1023 in order to qualify for exempt status. The agreement further provides that the U.S. will presume, in the absence of receiving certain financial information, that all Canadian registered charities are private foundations⁷⁹ and will not be listed in IRS Publication 78, “Cumulative Listing of Organizations.”⁸⁰ The advantage of such recognition is that it is automatic and no application is required to be made by the Canadian registered charities.

However, one of the many disadvantages⁸¹ of being deemed to be a private foundation is that the donors’ deductible contributions to those Canadian registered charities will be limited to 30% of the donors’ Canadian source income, rather than 50% for donations made to public charities. As a result, the Notice further indicates that if a Canadian registered charity would like to be listed in IRS

⁷⁹ In the United States, in general, charitable organizations are divided into two groups, public charities and private foundations, under section 501(c)(3) of the Code. All charitable organizations are deemed to be private foundations (which are subject to more stringent regulations) unless they qualify under section 509(a) of the Code. Generally, public charities have broad public support or actively function in a supporting relationship to such organizations. Private foundations, however, are charitable organizations that do not qualify as public charities. Generally, a private foundation is funded from one source, its ongoing funding is usually in the form of investment income (rather than from a flow of investment income), and it makes grants for charitable purposes to other persons (rather than conducting its own programs). See Bruce R. Hopkins, *The Law of Tax-Exempt Organizations* (8th ed.) (New Jersey: John Wiley & Sons, Inc.) at 274; and United States of America, Internal Revenue Service, *Private Foundations* (Washington D.C.).

⁸⁰ See also Canada Revenue Agency, *Registered Charities Newsletter* No. 6-1, *supra* note 49.

Publication 78, “Cumulative Listing of Organizations,” it will need to complete certain portions of IRS Form 1023, and submit a copy of its notification of registration issued by CRA and other documentation to the IRS. Further, if the materials submitted demonstrate that it is not a private foundation, it will be eligible to receive donations that are deductible to the extent of 50% of the U.S. donor’s Canadian source income as a public charity in the U.S. The Notice indicates that under the agreement, the recognition of exemption by IRS will terminate when the U.S. determines that the Canadian organization in question fails to satisfy the exemption requirements. Furthermore, Canadian organizations recognized as exempt will be required to file Form 990, Return of Organizations Exempt From Income Tax, or Form 990-F, Return of Private Foundation, where applicable, if they receive \$25,000 or more of U.S. source income.⁸² Failure to file the necessary forms will result in the organization being subject to a penalty under the Code.

2. Other Relief under the Act

The ability of U.S. charities to encourage Canadian donors to make generous gifts is fairly limited under Article XXI(6) of the Treaty. For those donors who do not have a substantial amount or any U.S.-source income, there would not be much, if any, incentive for them to make charitable donations to U.S. charities. However, certain types of U.S. charities that qualify under certain provisions of the Act would not be so restricted, including the donation of gifts by Canadian

⁸¹ There are many restrictions that apply to private foundations in the U.S., including “(1) the obligation of payment of a tax on net investment income; (2) probable inability of the organization to be funded by private foundations, because of the requirement that such grants be the subject of expenditure responsibility; (3) a lesser degree of deductibility of charitable contributions to the organization; (4) the fact that the charitable deduction for a gift of appreciated property to a private foundation generally is confined to its basis rather than the full fair market value of the property; (5) requirement of compliance with a broad range of onerous rules and limitations as to programs and investment policy; and (6) more extensive record-keeping and annual reporting requirements.” Hopkins, *supra* note 79 at 307.

⁸² Furthermore, section 6114(a) of the Code requires taxpayers claiming the benefits under paragraph 5 of Article XXI of the Treaty to file Form 8833 or to attach a statement to their income tax return indicating that they are claiming exemption or a charitable contribution deduction pursuant to Article XXI of the Treaty.

commuters to U.S. religious, charitable, scientific, literary or educational organizations; as well as the donation of gifts by Canadians to those U.S. charities that are qualified donees under the Act, namely prescribed universities, entities to which the Crown have made gifts, and agents of the United Nations. Donations made by Canadian donors to these U.S. charities are not restricted to the donors' U.S.-source income.

a) Canadian donors who are commuters

In situations where a Canadian donor resides in Canada near the Canada-U.S. border, gifts to certain U.S. charities are not limited to the Canadian donor's U.S.-source income. In order to qualify, the following requirements must be met: (1) the person resides in Canada near the Canada-U.S. border, (2) the person commutes to his or her principal place of employment or business in the U.S., (3) the person's chief source of income for the year is the said employment or business in the U.S, and (4) the donation is made to a religious, charitable, scientific, literary or educational organization created or organized in or under the laws of the U.S. that would be allowed as a deduction under the Code. If all of these requirements are met, then the donation made by that person to such a qualifying U.S. charity shall be treated as though it was a donation made to a registered charity in Canada.⁸³

It would appear that the rationale of this relief is to provide a tax benefit to those persons with very close ties with the U.S. It is likely for this reason that the Canadian government is not prepared to subsidize public funds to all U.S. tax-exempt entities under 501(c)(3) of the Code, but to limite to

⁸³ Subsection 118.1(9) of the Act. See also Arthur B. Drache, "Donating to U.S. Charities", 9(1) *Canadian Not-For-Profit News* (Carswell) 5-6 (January 2001).

benefits only to those U.S. charities that are “religious, charitable, scientific, literary or educational” in nature.

It is interesting to note that the qualifying U.S. charities are of a narrower category than those that generally qualify under Article XXI(6) of the Treaty. While all U.S. charities recognized under section 501(c)(3) of the Code qualify under Article XXI(6), only religious, charitable, scientific, literary or educational U.S. charity would qualify in relation to donations from commuters. Such a narrower category is the same as those that qualify under Article XXI(1) of the Treaty, which is reviewed on page 42 below.

b) Prescribed universities

Canadian donors are permitted to make charitable donations to foreign universities prescribed to be a university if their student body ordinarily includes students from Canada.⁸⁴ Pursuant to Regulation 3503, these universities are those named in Schedule VIII to the Act. CRA has indicated that in order to be recognized as a prescribed university, the institution must be a “university” and its student body must “ordinarily” include students from Canada. CRA clarified that the qualifying entities must be the universities themselves, and that an entity, *e.g.*, a centre or a foundation, whose activities and funds are dedicated to achieving the goals or the activities of a particular university would not qualify.⁸⁵ Institutions desiring to obtain this status must make an application to the

⁸⁴ Subparagraph 110.1(1)(a)(vi) and paragraph 118.1(1)(f) of the Act.

⁸⁵ Canada Revenue Agency, *Information Letter* CIL-1997-006, April 23, 1997.

International Tax Directorate.⁸⁶ CRA periodically reviews the list and has had institutions removed that have not had significant numbers of Canadian residents attend as students.⁸⁷

The main differences between a U.S. prescribed university and a U.S. college or university that receives gifts from its students, alumni and their family members are that the former (1) requires to be approved through an application process, (2) is not limited to receiving gifts from its students, alumni and their family members, and (3) may not be available for a “college” that does not qualify as a “university.”

c) Donee of Her Majesty in the Right of Canada

Canadian donors are permitted to make donations to charitable organizations outside of Canada to which Her Majesty in right of Canada (*i.e.*, the federal government or its agents)⁸⁸ has made gifts in the current year or in the previous calendar year.⁸⁹ For gifts made by corporations having a fiscal year which is not on a calendar basis, they may make gifts to these organizations to which the federal Crown has made gift in the corporation’s current fiscal year or in its previous fiscal year.⁹⁰

The list of qualifying charitable organizations is kept by CRA. It is updated if the government department or agency that makes an initial or subsequent gift to a foreign charitable organization on

⁸⁶ See Canada Revenue Agency, *Information Letter* CIL-1998-025, September 9, 1998. The application to become a prescribed university must include the following: (1) a letter or certificate from the appropriate educational authority in the country in which the institution is located confirming that it is empowered to issue degrees at least at the baccalaureate level according to the academic standards and statutory definition prevailing in that country; (2) a copy of a recent calendar or syllabus which describes course curriculum; and (3) enrolment records for the last ten years which indicate the number of Canadian students per semester or program year, and information such as their names, Canadian addresses, and degree program.

⁸⁷ Arthur B. Drache, “Schedule VIII Universities Under Review”, 7(8) *Canadian Not-For-Profit News* (Carswell) 58-59 (August 1999).

⁸⁸ Canada Revenue Agency, *Information Circular* IC84-3R5, “Gifts to Certain Charitable Organizations Outside Canada”, May 31, 2000.

⁸⁹ Paragraph 118.1(1)(g) of the Act.

behalf of the federal Crown provides CRA with details about the gift.⁹¹ The list is posted on CRA's website. The list of charitable organizations was last revised on July 13, 2007 and only included twelve entities, of which five are in the U.S.⁹²

In order to qualify as this type of charitable organization, the organization must have received a gift from the federal Crown. The meaning of "gift" is reviewed on page 9 above. It has been pointed out that the most notable recipients of gifts from the federal Crown are foreign organizations receiving grants from the Canadian International Development Agency ("CIDA"). However, it has been pointed out that in recent years CRA appears to have taken the position that the reporting requirements placed on CIDA grants would cause these grants not to qualify as gifts.⁹³

CRA indicates that they are responsible for determining whether the entity receiving a gift from the federal Crown is a "charitable organization" according to Canadian law, and whether the payment to the foreign entity is a "gift" at law.⁹⁴ CRA further indicates that to make such a determination, they would require to be provided with a copy of the governing document of the foreign entity; a copy of the letter or certificate issued by the foreign authority granting the foreign entity charitable

⁹⁰ Subparagraph 110.1(1)(a)(vii) of the Act.

⁹¹ *Supra* note 88 at para. 7.

⁹² Canada Revenue Agency, *Attachment to Information Circular IC84-3R5*, "Gifts to Certain Charitable Organizations Outside Canada", revised July 13, 2007. The twelve entities included Center for Strategic and International Studies, Council for Canadian American Relations Inc., Woodrow Wilson International Centre for Scholars, Village Focus International, and The American Assembly in the United States; Aga Khan Foundation and Aga Khan University Foundation in Switzerland; Canadian International School of Hong Kong Limited in Hong Kong; Cayman Islands National Recovery Fund in the Cayman Islands; The Foundation for Canadian Studies in the United Kingdom in the U.K.; The State Hermitage Museum in Russia; and Roman Catholic Archbishop of Kingston in Jamaica.

⁹³ Hayhoe 2004, *supra* note 6 at 926 to 947. See also Arthur B. Drache, *Canadian Taxation of Charities and Donations* (loose leaf) (Toronto: Thomson Canada Limited, 2005, 1994) at 10-19.

⁹⁴ Canada Revenue Agency, *Information Letter CIL-1999-016*, July 26, 1999; and *Information Letter CIL-1998-025*, September 9, 1998.

status; and copies of correspondence, agreements or other documentation relative to the Crown gift, and the amount and the date or anticipated date of the gift.⁹⁵

d) Agencies of the United Nations

Canadian donors are permitted to make charitable donations to the United Nations and its agencies.⁹⁶ Therefore, U.S. charities that are considered to be “agencies” of the United Nations would fall within in this category. However, it is not clear what entities are agencies of the United Nations for the purpose of the definition of qualified donees.

It is interesting to note that Regulation 8900 refers to “specialized agencies” of the United Nations, instead of simply agencies thereof. Employees of a “prescribed international organization” are entitled to a deduction under paragraph 110(1)(f) of the Act in computing taxable income equal to their income from employment with that particular organization. “Prescribed international organizations” are prescribed in Regulation 8900(1) to include “specialized agencies” that are brought into relationship with the United Nations in accordance with Article 63 of the Charter of the United Nations.⁹⁷

⁹⁵ *Ibid.*

⁹⁶ Subparagraph 110.1(1)(a)(v) and paragraph 118.1(1)(e) of the Act.

⁹⁷ The United Nations would include its Regional Commissions and other United Nations bodies. Article 63 of the Charter of the United Nations provides that the Economic and Social Council may enter into agreements with any of the agencies referred to in Article 57, defining the terms on which the agency concerned shall be brought into relationship with the United Nations. Article 57 of the Charter of the United Nations further provides that the various specialized agencies, established by intergovernmental agreement and having wide international responsibilities, as defined in their basis instruments, in economic, social, cultural, education, health, and related fields, shall be brought into relationship with the United in accordance with Article 63. Such agencies are referred to as “specialized agencies” within the United Nations system. For CRA’s view of the interpretation of the term “specialized agencies”, see CRA document number 9614035, May 1, 1996; document number 9715555, June 13, 1997; document number 2000-0004537, February 15, 2000; document number 2002-0143015, August 8, 2002; document number 2004-0101881E5, December 2, 2004; and document number 2005-0132721I7, June 7, 2005.

It is not clear why the definition for “agencies” of the United Nations for the purpose of qualified donees does not make reference to “specialized agencies” of the United Nations as in the case of Regulation 8900. Therefore, an argument may be made that the type of agency that would qualify as an agency of the United Nations for purposes of the definition of “qualified donee” is broader than those that would qualify under Regulation 8900.

C. RECEIPT OF INCOME IN CANADA

Other than soliciting donations from Canadian donors, many U.S. charities also carry on operations in Canada from which income may be derived, e.g. holding conferences and workshops, selling merchandise to further their charitable objects, etc. Since U.S. charities do not have charitable status under paragraph 149.1(1) of the Act, their operations may not necessarily be exempt from income tax in Canada. Rather, as non-residents in Canada, income earned by U.S. charities in Canada may be subject to non-resident taxes in Canada, unless they fall within one of the number of exemptions provided for under the Treaty or the Act.

In general, non-residents are subject to tax on their Canadian-source income.⁹⁸ Non-residents deriving active income (e.g., employment income, business income and capital gains from the disposition of taxable Canadian property) in Canada are subject to tax under Part I of the Act. The branch office of a non-resident corporation is also subject to a flat “branch tax” under Part XIV of the Act⁹⁹ on its after-tax business profits to the extent that the branch office repatriates its profits from Canada.¹⁰⁰ Furthermore, non-residents are subject to pay a flat 25% Part XIII withholding tax

⁹⁸ A detailed review of these rules is outside the scope of this paper. For an overview, see Michael I. Atlas, *Canadian Taxation of Non-Residents*, 2nd ed. (Toronto: CCH Canada, 2002); and Wanda Rumball, “Dealing with Non-Residents: then Basis,” 2005 Conference Report 39:1 (Toronto: Canadian Tax Foundation, 2005).

⁹⁹ Section 219 of the Act.

¹⁰⁰ See *infra* note 171.

on Canadian passive income (*e.g.*, interest, dividends, rent, royalties, etc.).¹⁰¹ These taxes on non-residents also generally apply to income earned by U.S. charities in Canada.

In this regard, Article XXI(1) allows reciprocal recognition of tax exemption status for “religious, scientific, literary, educational or charitable organizations” so that certain income earned by U.S. charities in Canada is exempt from Canadian tax under the Act. Similarly, certain income earned by Canadian charities in the U.S. is exempt from U.S. tax under the Code. Furthermore, other provisions of the Treaty also provide reciprocal tax exemption, *e.g.*, certain income may be exempt from tax pursuant to Article VII of the Treaty by virtue of the income not being business profits derived from a permanent establishment in the other country. Lastly, other relief from tax are provided under the Act or the Code, as applicable. For example, if a U.S. charity is not one of the five enumerated categories of charities in the U.S., it may qualify as a non-profit organization in Canada under paragraph 149(1)(l) of the Act.

1. Article XXI(1) Exemption

Article XXI(1) of the Treaty provides as follows:

1. Subject to the provisions of paragraph 3, income derived by a religious, scientific, literary, educational or charitable organization shall be exempt from tax in a Contracting State if it is resident in the other Contracting State but only to the extent that such income is exempt from tax in that other State.

¹⁰¹ The 25% tax is reduced under the Treaty in some cases. For example, cross-border interest payments are currently subject to a reduced 10% withholding tax under the Treaty. Under the Fifth Protocol, the withholding tax will be eliminated on arm’s length interest paid as of the second month after the protocol comes into force. Withholding tax on interest payments between related parties will be gradually reduced to 0% over 3 years the Protocol comes into force. There is also a limited withholding tax under Part I of the Act on income from employment in Canada and fee for providing services (other than employment) in Canada. The 15% withholding tax under Regulation 105 is reduced to 10% on the first \$5,000 paid to a non-resident who provides independent personal services pursuant to Article XVII of the Treaty.

Article XXI(3) further provides that the exemption provided by Article XXI(1) does not apply to the “income of a trust, company, organization or other arrangement from carrying on a trade or business or from a related person” other than an organization referred to in Articles XXI(1) or XXI(2).¹⁰²

Pursuant to the Fifth Protocol, Article XXI(3) will be renumbered to be Article XXI(4). Article XXI(2) of the Treaty currently provides an exemption for dividends and interest earned by tax-exempt entities resident in the U.S. that operate to administer or provide pension, retirement or employee benefits, as well as other U.S. tax-exempt entities that earn income to these entities. These entities are not relevant for purposes of this paper.

However, pursuant to the Fifth Protocol, Article XXI(2) will be revised and a new Article XXI(3) will be inserted. The effect of these changes is to provide that dividend income (referred to in Article X) and interest income (referred to Article XI) earned by charities (i.e. entities that meet the requirements set out in Article XXI(1)) would be exempt from income tax., provided that the income is not derived from carrying on a trade or business or from a related person other than an organization referred to in Articles XXI(1), or the new Articles XXI(2) and Article XXI(3).

Therefore, in order for a U.S. charity to benefit from the tax exemption under Article XXI(1), it must meet a number of requirements, namely, (1) the organization must be a “religious, scientific, literary, educational or charitable organization;” (2) the organization must be resident in the U.S.; and (3) income derived by the organization in Canada is not derived from the carrying on of a trade

¹⁰² Further, Article XXI(4) of the Treaty exempts an organization which is resident in Canada and which has received substantially all of its support from persons other than citizens or residents of the U.S. from U.S. excise taxes imposed with respect to private foundations. Article XXI(4) will be renumbered to be Article XXI(5) pursuant to the Fifth Protocol.

or business or from a related person that is not an organization referred to in Articles XXI(1) or XXI(2). Similarly, in order to dividend income and interest income be exempt from tax pursuant to the new Article XI(3), the same requirement would also need to be met. Each of these requirements is reviewed below.

a) Religious, scientific, literary, educational or charitable organization

In order to qualify for income tax exemption under Article XXI(1), the U.S. charity must demonstrate that it is a “religious, scientific, literary, educational or charitable organization.” It is therefore important to understand what is meant by this phrase in order to be able to determine what organizations would qualify under this exemption. It is also important to determine whether the application of this phrase would differ in the U.S. context from the Canadian context. However, it appears that neither of these issues has a clear answer.

In a 1990 technical interpretation,¹⁰³ CRA was asked whether a trust whose income is exempt in its own hands and in the hands of its beneficiaries is a “resident of a contracting state” for treaty purposes. CRA indicated that it had not adopted a position in relation to the meaning of this phrase “religious, scientific, literary, educational or charitable organization” as used in Article XXI(1) of the Treaty. Furthermore, CRA indicated that it was not clear whether the term “charitable organization” in Article XXI(1) carries the same meaning as “charitable organization” as defined in paragraph 149.1(1)(b) of the Act. Rather, CRA responded that in such a situation, the issue to be determined was whether the trust in question was exempt from tax in the U.S. by virtue of it being

¹⁰³ Canada Revenue Agency document number OC90_351_353, October 1, 1990.

considered in the U.S. as “a religious, scientific, literary, educational or charitable organization.” However, CRA did not provide any reasoning in support of its view.

It is important to note that the phrase “religious, scientific, literary, educational or charitable organization” constitutes only five of the eight enumerated categories of charities set out in section 501(c)(3) of the Code, which provides as follow:

Corporations, and any community chest, fund or foundation, organized and operating exclusively for religious, charitable, scientific, testing for public safety, literary or educational purposes, or to foster national or international amateur sports competition (but only if no part of its activities involve the provision of athletic facilities or equipment), or for the prevention of cruelty to children or animals

As such, the types of U.S. charities that qualify for benefits under Article XXI(6) are much broader than the U.S. charities that would qualify for Treaty benefits under Article XXI(1). Treaty benefits under Article XXI(1) are restricted to “religious, scientific, literary, educational or charitable” organizations. However, treaty benefits under Article XXI(6) are available to all U.S. charities that are tax-exempt pursuant to section 501(c)(3) of the Code, which sets out eight enumerated categories of charities.¹⁰⁴ There are a number of issues that may arise in this regard.

First, the term “charitable organization” is used in Article XXI(1), but it is not defined in the Treaty. This term is used in both the Code and in the Act, with each carrying a different meaning. In the Canadian context, the word “charitable” carries a common law meaning. The term “charitable organization” represents one of three types of registered charities defined in subsection 149.1(1) of the Act, with the other two types being “public foundations” and “private foundations.” All

¹⁰⁴ See Arthur B. Drache, “Competent Authority Guidelines” (1999), vol. 7, no. 12 *Canadian Not-for-Profit News* 94-95, at 95.

registered charities in Canada are required to have exclusively charitable purposes as recognized at common law by the courts, namely relief of poverty, advancement of education, advancement of religion, or other purposes beneficial to the community in a way the law regards as charitable.¹⁰⁵ It is possible for charities to be established to carry out activities under only one of these heads of charity or under more than one of these heads. Therefore, from the perspective of the common law meaning of the word “charitable,” it would encompass organizations that are established for religious, scientific, literary or educational purposes, *i.e.*, the other purposes enumerated in Article XXI(1).

However, in the U.S. context, the word “charitable” carries a meaning in its “popular and ordinary sense” and not in the common law sense. In this regard, “charitable organizations” referred to in section 501(c)(3) of the Code represent only one of the eight enumerated categories of organizations in that section. It has been pointed out that the eight enumerated categories of organizations are in the disjunctive, supporting an argument that Congress intended to recognize each category of purpose for a function enumerated therein as a distinct basis for tax exemption.¹⁰⁶ Sometimes, in the U.S., organizations listed in section 501(c)(3) of the Code are often simply referred to as “charitable organizations” in a generic sense.¹⁰⁷ Furthermore, after reviewing the history of the U.S. Congress enacting and perpetuating income tax exemption for organizations listed in section 501(c)(3) of the Code, it has also been pointed out that Congress intended to use the word “charitable” in its “popular and ordinary sense” and not in the common law sense.¹⁰⁸ If the

¹⁰⁵ See *supra* note 72.

¹⁰⁶ Hopkins, *supra* note 79 at 106 - 107.

¹⁰⁷ Hopkins, *supra* note 79 at 103.

¹⁰⁸ Hopkins, *supra* note 79 at 104 – 111.

meaning of the word in the common law sense was intended by Congress, it would render the other categories enumerated in section 501(c)(3) of the Code redundant.¹⁰⁹

Section 501(c)(3) of the Code provides income tax exemption for eight enumerated organizations. Only five of the eight enumerated categories are set out in Article XXI(1). The three enumerated categories that have not been included in Article XX(1) are testing for public safety, fostering national or international amateur sports competition (but only if no part of its activities involve the provision of athletic facilities or equipment), and preventing cruelty to children or animals.

No explanation has been provided in the technical explanation to the Treaty as to why these three categories were not included, especially in relation to the category of “preventing cruelty to children or animals” because this would be recognized as charitable at common law.¹¹⁰ In relation to the category of “testing for public safety,” while the preservation of public order and protection of lives and property, including local defence, armed forces, national defence, protection of property, etc., are recognized to be charitable at law in Canada,¹¹¹ it is not clear whether the “testing” for public safety would be charitable at law. Although “fostering national or international amateur sports competition” is recognized as tax-exempt under section 501(c)(3) of the Code, CRA takes the position that the promotion of sport is not a charitable purpose at common law. Therefore, an organization established to promote a particular sport cannot be registered as a charity in Canada.¹¹² However, the use of sport to further a charitable purpose can qualify for registration as a charity, e.g., sports that are part of a school curriculum meet this criterion, as do youth programs and

¹⁰⁹ *Ibid.*

¹¹⁰ *Tudor on Charities, supra* note 105 at 98-103 and 118-120.

¹¹¹ *Tudor on Charities, supra* 105 at 93-97.

¹¹² *A.Y.S.A Amateur Youth Soccer Association v. Canada* (Canada Revenue Agency) (2007 SCC 42 , 2007 DTC 5527; affirming 2006 F.C.A. 136).

community facilities that organize sports as an incidental activity, such as sport-related programs that help seniors or persons with disabilities.¹¹³

The difference in the meaning of the word “charitable” and the phrase “religious, scientific, literary, educational or charitable organization” would need to be interpreted differently depending on which country is to apply this provision in a particular situation. Article III(2) of the Treaty provides that, in the case of a term not defined in the Treaty, the domestic tax law of the contracting state applying to the Treaty shall control, unless the context in which the term is used requires a definition independent of domestic tax law or the competent authorities reach agreement on a meaning pursuant to Article XXVI (Mutual Agreement Procedure).

Therefore, in situations where U.S. charities are seeking the benefits of Article XXI(1), it would appear only those five categories would be eligible for benefits under this Article. Perhaps this is the basis why U.S. charities seeking Treaty benefits under Article XXI(1) are required to submit an application to CRA, while Canadian charities seeking reciprocal Treaty benefits are not required to do so. The recognition process is reviewed on page 57 below.

However, in situations where Canadian registered charities are seeking the benefits of Article XXI(1), it would be helpful if clarification were provided in relation to how the phrase “religious, scientific, literary, educational or charitable organization” is to be interpreted in the context of Canadian law, which categorize charities according to the four recognized heads of charitable purposes at common law.

¹¹³ Canada Revenue Agency, *Summary Policy* CSP - S14, “Sport,” September 3, 2003; Canada Revenue Agency, *Registered Charities Newsletter* No. 20, Fall 2004.

b) U.S. charities resident in the U.S.

In order to qualify for income to be exempt from tax in a contracting state under Article XXI(1), the U.S. charity in question must be resident in the U.S. The issue of residency requirement is required on page 22 above.

c) Type of exempt-income

In addition to receiving charitable donations from Canadian donors, a U.S. charity may derive income from various activities in Canada, *e.g.*, membership fees, workshop and conference fees, sale of merchandise, interests, royalty fees, license fees, rental income, fees for rendering services, etc. Whether income earned by U.S. charities in Canada would be exempt from Canadian income tax pursuant to Article XXI(1) of the Treaty would depend on whether the restrictions set out in Articles XXI(1) and XXI(3) are met. Income derived by U.S. charities in Canada that is not exempt under Article XXI(1) of the Treaty may be subject to tax in Canada pursuant to Article VII of the Treaty if that income is derived through a permanent establishment in Canada. This issue is reviewed on page 59 below.

Requirements that must be met by U.S. charities wishing to enjoy the tax exemption offered by Article XXI(1) include (a) the exempt income must not be derived from carrying on a trade or business; (b) the exemption does not apply to income earned by a related person, unless that person is a U.S. charity referred to in Article XXI(1) or a pension, retirement or employee benefits plan referred to in Article XXI(2); and (c) the exemption is limited only to such income that is exempt from tax in the U.S. As indicated above, similar requirements must also be met in order to take advantage of the tax exemption for dividend income and interest income pursuant to the new Article

XXI(3) pursuant to changes introduced by the Fifth Protocol. Each of these requirements is reviewed in this section of the paper.

i) Carrying on trade or business

Pursuant to Article XXI(3), the exemption in Article XXI(1) for income earned in Canada does not apply to income derived from carrying on a trade or business. CRA explained in a technical interpretation¹¹⁴ that Article XXI(3) would override the exemption provided in Article XX(1) only to the extent of that organization's income derived from carrying on a trade or business. Therefore, the type or source of the income is not determinative of whether the income is tax exempt, but rather the nature of activity from which income is derived. For example, rental income received by a U.S. charity could be income from an active rental business or could be income from the passive investment in real property held by the charity.¹¹⁵ In CRA document number 9324915,¹¹⁶ a U.S. charity asked CRA whether farm income earned by the U.S. charity in Canada would be tax exempt pursuant to Article XXI(1). CRA indicated that it is a question of fact whether the farm income would be tax exempt. If it is derived from the U.S. charity's share of farming profits from active farming operation (*e.g.*, the U.S. charity is a proprietor or partner in an actual farming operation), then the farm income would constitute income from carrying on a trade or business and would not be exempt from Canadian tax. However, if the farm income represents profits from the leasing of land and buildings to other parties (*e.g.*, Canadian farmers), then such income may constitute investment income (*i.e.*, income from property) and therefore be exempt from Canadian tax, provided that such income is otherwise exempt from U.S. tax.

¹¹⁴ Canada Revenue Agency, document number 9531465, January 10, 1996.

¹¹⁵ *Ibid.*

¹¹⁶ Canada Revenue Agency, document number 9324915, March 25, 1994.

The phrase “carrying on a trade or business” is not defined in the Treaty.¹¹⁷ “Business” is not exclusively defined in the Act. At common law, it is usually referred to as “anything which occupies the time, attention and labour of a man for the purpose of profit.”¹¹⁸ Generally, the level of activity involved in an endeavour would determine whether the income is derived from a business (where the income is derived from the activity of the owner or the owner’s employees), or whether the income is derived from property or passive investment (where the income is derived from the ownership of property).¹¹⁹ The meaning of “carrying on business” is generally determined by common law. When determining whether a non-resident is carrying on business in a particular country, the courts usually review where the contract is made,¹²⁰ and/or the place of operations from which profits arise.¹²¹ Other than the common law test, an extended meaning of “carrying on business in Canada” is found in section 253 of the Act. If a non-resident does not appear to be carrying on a business in Canada pursuant to the common-law principle, it may be deemed to be doing so under the situations set out in that section, *e.g.*, produces or manufactures anything in Canada, solicits orders or offers anything for sale in Canada through an agent or servant, or disposes of certain Canadian property in Canada.¹²²

¹¹⁷ For an overview of this issue, see Faye Brown, “An Introduction to Carrying On Business in Canada, Permanent Establishments, and Part XIII Tax,” *Report of Proceedings of Fifty-Sixth Tax Conference*, 2004 Tax Conference (Toronto: Canadian Tax Foundation, 2005), 38:1-20 at 38:2 to 38:7; Jas Hayre, CA, “Non-Residents Carrying on Business in Canada,” *2002 British Columbia Tax Conference*, (Vancouver: Canadian Tax Foundation, 2002), 12:1-27.

¹¹⁸ *Smith v. Anderson* (1880), 15 Ch. D. 247 (C.A.); *Stewart v. Canada* [2002] S.C.J. No. 46, [2002] 3 C.T.C. 439, 2002 D.T.C. 6969 (S.C.C.).

¹¹⁹ *Li et al.*, *supra* note 10 at 90.

¹²⁰ For example, see *Crookston Bros. v. Furtado* (1910), 5 D.T.C. 602. (Scot. Ex. Ct).

¹²¹ For example, see *M.N.R. v. Gurd's Products Co.*, [1985] F.C.J. No. 606 (F.C.A.), leave to S.C.C. refused 64 N.R. 156n.

¹²² Paragraph 253 (a), (b) and (c).

It is a question of fact whether certain income is income from carrying on a trade or business.¹²³

When asked what factors are used in determining whether a U.S. charity is carrying on a business or trade, CRA made reference to the same factors used for determining whether a non-profit organization under paragraph 149(1)(l) of the Act is carrying on a trade or business. Paragraph 7 of CRA's Interpretation Bulletin IT-496R provides as follows:

It will be a question of fact to be determined with regard to the particular circumstances as to whether an association is carrying on a trade or business and if so, whether it will result in finding that an association is not operated exclusively for non-profit purposes. Some characteristics that might indicate that an activity is a trade or business are as follows:

- (a) it is a trade or business in the ordinary meaning, that is, it is operated in a normal commercial manner;
- (b) its goods or services are not restricted to members and their guests;
- (c) it is operated on a profit basis rather than a cost recovery basis; or
- (d) it is operated in competition with taxable entities carrying on the same trade or business.

Generally, the carrying on a trade or business directly attributable to, or connected with, pursuing the non-profit goals and activities of an association will not cause it to be considered to be operated for profit purposes.

[Emphasis added]

In general, the income generating activity cannot be the principal activity of the corporation and must be carried on, and the resulting income must be used, by the corporation in carrying out its exempt objectives.¹²⁴ An organization may carry on income generating activity provided that there is a casual relationship between the profit-making activity and the exempt purpose of the

¹²³ See Canada Revenue Agency, document number 9531465, January 10, 1996; income tax ruling, 9635823, April 4, 1997; and Canada Revenue Agency, T4016, "Exempt U.S. Organizations under Article XXI of the Canada-United States Tax Convention," March 31, 2007.

¹²⁴ Canada Revenue Agency, document number 9704605, February 17, 1998.

organization.¹²⁵ A detailed review of the law in relation to what would constitute income from carrying on a business or trade for a non-profit organization is beyond the scope of this paper.¹²⁶

Another CRA publication not mentioned by CRA, but one which may shed light on some of the criteria that may be considered when determining whether a charity is deriving income from its charitable activities or by carrying on a trade or business, is CRA's policy statement CPC-019 on related business.¹²⁷ CRA's related business policy indicates that whether a particular activity of a charity is a business depends on the facts in each case. The following are some of the criteria established by the courts:¹²⁸

- The intended course of action - If the rationale for operating a given activity is to generate a profit, then the activity is likely a business.
- The potential to show a profit - Even if an activity does not yield a profit, it may nonetheless be capable of earning a profit. In determining whether a particular activity is a business, it is the intention and capacity to make a profit at some point that are relevant. On the other hand, if the activity is structured so that it is incapable of returning a profit, then it is not a business.
- The existence of profits in past years - When the activity has been carried on for some time, a history of it returning a profit would generally imply that a business exists.
- The expertise and experience of the person or organization that undertakes the activity - If the person or organization that is undertaking the activity has been selected for the position because of his/her/its commercial knowledge, skill, or experience, it may indicate that the activity is commercial in nature and so may be a business.

¹²⁵ Canada Revenue Agency, document number 2002-0153887, August 19, 2002.

¹²⁶ Robert B. Hayhoe, "An Updated Introduction to the Taxation of Nonprofit Organizations" *The Philanthropist Volume* 18, No. 2, at page 94, and Canada Revenue Agency, document number 2002-0153887, August 19, 2002. This document provides a helpful overview of the jurisprudence on issues involving non-profit organizations. See also *Gull Bay Development Corporation v. Her Majesty the Queen* 84 D.T.C. 6040 (F.C.T.D.) and *L.I.U.N.A. Local 527, Members' Training Trust Fund v. M.N.R.* [1992] 2 C.T.C. 2410, 92 D.T.C. 2365 (T.C.C.).

¹²⁷ Canada Revenue Agency, *Policy Statement* CPS-019, March 31, 2003.

¹²⁸ *Supra* note 127 at para. 4. See also *Stewart v. Canada*, *supra* note 118.

The related business policy further explains that “carrying on” a business implies that the commercial activity is a continuous or regular operation.¹²⁹ CRA explains that a charity can engage in some business-like transactions, provided they are not operated regularly or continuously. CRA’s related business policy also clarified whether income derived from the following activities commonly undertaken by charities is income derived from carrying on a business. Many of these activities are commonly undertaken by U.S. charities operating in Canada, a brief review of CRA’s view on the nature of these activities would be helpful.

(1) Solicitation of donations and selling of donated goods

The solicitation of donations and selling of donated goods are not considered to be business activities.¹³⁰ The solicitation of donations is not a commercial activity because donors do not expect any good or service in return for their contributions. The sale of donated goods is not a commercial activity because businesses do not depend on donations to create their inventories. Further, in selling off donated items, the charity does not assume the costs or level of risk usually associated with running a business. Rather, it merely seeks to convert a donated asset into cash.¹³¹ CRA indicates that since these activities are not commercial, they are not considered to be businesses.

(2) Events that charges fees

CRA acknowledges that fees are charged in the context of many charitable programs and that the presence of fees does not necessarily mean that a program is non-charitable or that the charity is

¹²⁹ *Supra* note 127 at para. 9.

¹³⁰ *Supra* note 127 at para. 5.

¹³¹ See *Alberta Institute on Mental Retardation v. Canada*, [1987] 3 F.C. 286, (1987) 76 N.R. 366, [1987] 2 C.T.C. 70, (1987) 87 D.T.C. 5306 (F.C.A.), leave to appeal dismissed, (1988) 87 C.R. 397, [1988] S.C.C.A. No. 32 (S.C.C.). But see *Earth Fund v. Canada (M.N.R.)*, 2002 F.C.A. 498.

engaging in a business activity.¹³² Programs remain charitable as long as they manifest the two essential characteristics of charity, *i.e.*, altruism (which means “giving to third parties without receiving anything in return other than the pleasure of giving”) and public benefit.¹³³

(3) Fundraising activities

CRA acknowledges that although most fundraising activities are “business” activities,¹³⁴ they are mostly not affected by the related business provisions because they do not amount to “carrying on” a business.¹³⁵ CRA further indicates that even if fundraising events are “business” activities, they would not amount to “carrying on” a business if the following factors are satisfied:¹³⁶

- A fundraising event has clear “start” and “end” points. In contrast, carrying on a business implies continuous operations.
- A fundraising event of a particular type does not recur with such regularity and frequency that it amounts to carrying on a business.

(4) Passive investments

¹³² *Supra* note 127 at para. 6.

¹³³ *Vancouver Society of Immigrant and Visible Minority Women v. M.N.R.*, [1999] 1 S.C.R. 10. CRA’s policy indicates that examples of charitable programs that could charge fees include rent in low-income housing programs, university tuition fees, and museum admission. Another example includes “‘training businesses’ (which provide on-the-job training in vocational and life skills),” described in CRA’s Guide RC4143(E), “Community Economic Development Programs” December 23, 1999. The CED policy explains that the key to determining whether an activity is a “charitable program in its own right (as opposed to a potentially ‘related’ business) is to determine whether its focus is on helping the clientele or on making a profit.”

¹³⁴ U.S. charities that carry on fundraising activities in Canada may be required to comply with the applicable provincial fundraising legislation. For a review of related issues, see Esther S.J. Oh and Jacqueline M. Connor, “Extra-provincial Corporate and Fundraising Compliance for Charities,” a paper presented at the Second National Symposium on Charity Law “What’s New and What’s Coming,” April 14, 2004.

¹³⁵ *Supra* note 127 at para. 11, 12, 13.

¹³⁶ *Supra* note 127 at para. 12. For example, in *Earth Fund v. Canada (M.N.R.)*, 2002 F.C.A. 498, the court held that the appellant’s lottery activity was a commercial activity rather than a fundraising activity.

The appellant proposes to do nothing except market and sell lottery tickets in a manifestly commercial arrangement that will, if all goes as planned, result in a profit that will be donated, I assume, to qualified donees. The appellant is in exactly the same position as any commercial enterprise that commits itself to apply its profits to charitable causes. Such a commitment, by itself, does not derogate from the commercial nature of the activity that generates the profit. Given the particular facts of this case, the Minister was justified in concluding that the appellant's proposed lottery operation would be a business of the appellant that is not a "related business", and thus would not qualify as a charitable activity.

CRA also indicates that deriving income from investments is usually not deriving income from carrying on a business. Although both businesses and investments depend on the use of assets, deriving income from investments share the following common characteristics:¹³⁷

- Investment income is derived primarily from the mere ownership of the asset. It is not dependent on active trading such as conducted by dealers who buy an asset in order to sell it as soon as possible at a profit, or the exploitation of the asset such as conducted by manufacturers or resource companies.
- With investment income, the risk to the charity is generally limited to the purchase price of the asset.
- Deriving investment income is also fundamentally a passive activity, in that it does not call upon the charity to take any active role in operating the underlying business.

(5) Income through partnership interest

When a charity holds an interest in a partnership or limited partnership, the earning of income through the ownership of a partnership interest, however, is generally not recognized as a passive investment but the earning of income from an active business, even though the charity may play no active role in the business.¹³⁸ However, it is possible that passive property income may be derived through the partnership as well.

CRA document number 9219352¹³⁹ involved a U.S. charity proposing to become a limited partner in a limited partnership, which would invest in shares of Canadian corporations. CRA was asked whether the capital gains and dividends the U.S. charity had derived from the limited partnership would be subject to tax in Canada. CRA indicated that where the U.S. partnership is not taxed as

¹³⁷ *Supra* note 127 at para. 14.

¹³⁸ *Supra* note 127 at para. 16. See Canada Revenue Agency, document number 9219352, October 19, 1992. In relation to income earned by U.S. charities from a trust resident in Canada, see Canada Revenue Agency, document number 9635823, April 4, 1997; document number 9625935, February 17, 1997; document number 9729263, March 17, 1998.

¹³⁹ Canada Revenue Agency, document number 9219352, October 19, 1992.

a separate entity in the U.S., for purposes of Treaty the partnership would be treated as a conduit. Accordingly, a U.S. charity that is a member of such a partnership would be entitled to the benefits of Article XXI(1) of the Treaty on its share of partnership income subject to the limitations described in Article XXI(3), subject to certain conditions. Where a partnership or a limited partnership carries on business, the business operations carried on by the partnership or limited partnership are regarded as being carried on by the partners directly, to the extent of the partner's interest in the partnership. It is a question of fact whether the activities carried out by a partnership constitute carrying on business. Where the investment activities of the limited partnership constitute carrying on business, the U.S. charity's share of business income from the partnership would not be subject to Article XXI(1) by virtue of Article XXI(3). Such income would be subject to Article VII of the Treaty and Canada's right to tax that income would depend on whether the partnership was considered to have carried on business in Canada through a permanent establishment situated in Canada. However, CRA indicated that it does not rule out the possibility that a partnership can earn property income. However, in their opinion, where the only activity of the partnership is the investment in shares of various corporations, such activity will likely be considered a business activity.

ii) Income from related persons

The exemption does not apply to income earned by a related person, unless that person is a U.S. charity referred to in Article XXI(1) or a pension, retirement or employee benefits plan referred to in Article XXI(2).

The term "person" is defined in Article III(1)(e) of the Treaty to include an individual, an estate, a trust, a company and any other body of persons. Since the both the U.S. and Canada does not regard

partnerships as taxable entities, the definition in Article III(1)(e) is broad enough to include partnerships.¹⁴⁰

The meaning of the term “related” for purpose of Article XXI is not defined in the Treaty.¹⁴¹ Article III(2) of the Treaty provides that unless the context otherwise requires, any term not defined in the Treaty has the meaning under the laws of the country concerning the taxes to which the Treaty applies. Section 3 of the *Income Tax Convention Interpretation Act*¹⁴² provides that any terms not defined or fully defined in a treaty or is to be defined by reference to the laws of Canada, has, except to the extent that the context otherwise requires, the meaning it has for the purpose of the Act, as amended from time to time, and not the meaning it had for the purposes of the Act on the date the treaty was entered into or given the force of law.¹⁴³ In relation to U.S. charities seeking the benefits of Article XXI(3), the meaning of the term “related” set out in subsections 251(2) to (6) of the Act would apply.¹⁴⁴ Therefore, income derived from a related U.S. charity that meets the requirements of Article XXI(1) would also be exempt.

iii) Exempt income in the U.S.

Article XXI(1) provides that the exemption is limited only to such income that is exempt from tax in the U.S. Therefore, income that is not exempt under the law of the U.S. would also not be

¹⁴⁰ Vern Krishna, *The Canada-U.S. Tax Treaty, Text and Commentary* (Toronto: LexisNexis, 2004) at 17, 167, 168.

¹⁴¹ The meaning of the term “related” is referred to in Article IX(2). Article IX of the Treaty recognizes the right of U.S. and Canada to make an allocation of income to that country in the case of transactions between related enterprises. However, the meaning of the term “related” set out in Article IX(2) is only for the purpose of Article IX and therefore has no application to Article XXI. See Krishna, *supra* note 140 at 54.

¹⁴² R.S.C. 1985, c.14.

¹⁴³ Li *et al.*, *supra* note 10 at 39.

¹⁴⁴ See also Canada Revenue Agency, *Interpretation Bulletin* IT-419R2, “Meaning of Arm’s Length,” June 9, 2004; *Interpretation Bulletin* IT-64R4 (Consolidated), “Corporations: Association and Control,” October 2004.

exempted from tax in Canada. Similar reciprocal restrictions apply to the exemption of income earned by Canadian charities in the U.S.

Under the Code, U.S. charities are subject to U.S. tax on their net income derived from their unrelated trade or business or business activities. U.S. charities are permitted to engage in some activities that are not related to their exempt purposes. In general, income from a trade or business, regularly carried on, that is not substantially related to the charitable, educational or other purpose that is basis for the organization's exemption.¹⁴⁵ CRA pointed out in its publication T4016¹⁴⁶ that in most cases, where income would be treated as "unrelated business income" under the Code, it is "probable" that CRA would conclude that the income so categorized is from carrying on a business.¹⁴⁷

d) Recognition procedure

It has been pointed out on page 29 above that U.S. charities seeking Treaty benefits under Article XXI(6) of the Treaty can do so if they qualify under section 501(c)(3) of the Code. They do not need to apply to CRA, although they may have to show proof that they qualify under the Code. However, in order to seek benefit under Article XXI(1) of the Treaty, U.S. charities are required to submit an application to CRA's International Tax Services Office.

¹⁴⁵ See IRS, Publication 557, "Tax-exempt Status of your Organization," March 2005, Hopkins *supra* note 79 at 744, 745.

¹⁴⁶ Canada Revenue Agency, T4016, "Exempt U.S. Organizations under Article XXI of the Canada-United States Tax Convention," March 31, 2007.

¹⁴⁷ *Ibid.* Publication T4016 also indicates that where the organization has arranged, under written contract or otherwise, with others for the performance of a service in Canada those persons may be subject to Canadian withholding tax on any income accruing to them in respect of services performed in Canada.

In this regard, paragraph 78 of CRA's *Information Circular* IC77-16R4¹⁴⁸ indicates that an "application under Article XXI should be made" by letter, accompanied by: (1) a certified copy or a photocopy of the charter, articles of incorporation or similar instrument setting out the purposes of the organization; and (2) a letter of determination by the IRS in the U.S. as to the status of the organization under the Code. The application is processed by CRA's International Tax Services Office, Non-Residential Withholding Division in Ottawa. Approved organizations will be granted a letter of exemption and will be listed in CRA's publication "Exempt U.S. Organizations under Article XXI of the Canada-United States Tax Convention" (T4016). The list was last revised on March 31, 2007.

CRA's T4016 sets out a sample letter of exemption issued by CRA to successful applicants. Successful applicants will be issued an identification number. The sample letter contemplates that applications for such exemption also need to be accompanied by a description of the types of income that the U.S. charities want to have exempted. The letter of exemption will be limited to the type of income set out therein for the period of time set out in the letter. Upon expiry of the exemption period set out in the letter of exemption, an application to renew the exemption will need to be submitted to CRA. U.S. charities are also required to notify CRA if there are any changes to the U.S. charity's exempt status under the Code, the IRS's determination of the exempt activities of the U.S. charity, and/or the objectives, purpose or name of the U.S. charity.

Persons paying amounts to an U.S. charity listed in CRA's T4016 are not subject to Canadian income tax for which exemption is granted in the letter of exemption, including non-resident

¹⁴⁸ Canada Revenue Agency, *Information Circular* IC77-16R4, "Non-Resident Income Tax," May 11, 1992. See also Joel A. Levitt, C.A., "Cross-Border Services: Regulation 105 and Part XIII," 1997 *Ontario Tax Conference*, (Toronto:

withholding tax under Part XIII of the Act. A U.S. charity which is not listed in T4016 may provide the payer with a copy of the letter of exemption. This letter would qualify as authority for exemption from the Part XIII withholding tax.

2. Other Possible Exemptions

However, in the event that the income of a U.S. charity does not qualify for exemption under Article XXI(1) of the Treaty, *e.g.*, if the charity has income earned as a result of carrying on a business or trade, or if the U.S. charity is not one of the five enumerated categories of charities in the U.S., there are a number of other provisions under which the U.S. charity may not be subject to tax in Canada, namely if the income derived by the U.S. charity does not arise from a permanent establishment in Canada or if the U.S. charity qualifies as a non-profit organization in Canada.

a) No permanent establishment in Canada

Pursuant to Article VII(1), business profits of a U.S. charity shall be taxable in Canada if it carries on business in Canada through a permanent establishment in Canada. Article VII(1) also requires that the tax on the business profits of the U.S. charity is limited to those attributable to that permanent establishment. Therefore, in order to attract tax in Article VII, it requires three elements: (1) business profits, (2) a permanent establishment in Canada, and (3) profits attributable to the permanent establishment. Therefore, if the income derived by a U.S. charity in Canada is not tax-exempt under Article XXI(1) of the Treaty, but the income does not meet the requirements in Article VII(1), it may not be subject to tax in Canada, provided that the income is not taxable under other provisions of the Treaty.

Canadian Tax Foundation, 1997), 10:1-32.

i) Business profits

The term “business profits” is not defined in the Treaty. Presumably, it means profits earned in the course of carrying on a business. The circumstances in which an entity would be carrying on a trade or business is reviewed on page 48 above.¹⁴⁹

Business profits are taxable under Article VII only to the extent that they are *attributable to a permanent establishment* of the U.S. charity in Canada.¹⁵⁰ Article VII(2) of the Treaty provides that the business profits of a permanent establishment are determined as if the permanent establishment were a distinct and separate person engaged in the same or a similar activity under the same or similar conditions and dealing wholly independently with the U.S. resident or anyone related to the U.S. charity. In determining the business profits, deductions for expenses, wherever incurred, are allowed for those incurred for the purpose of that permanent establishment.¹⁵¹ The only business profits that can be attributable to a permanent establishment are those derived from the assets or activities of the permanent establishment itself.¹⁵² However, this provision does not preclude Canada from using appropriate rules of domestic law in determining the attribution.

Article VII(6) also provides that where business profits include items of income that are dealt with separately in other Articles of the Treaty, then those other Articles and not Article VII will govern the treatment of those types of income. For example, film rentals are taxed under Article XII as

¹⁴⁹ For an overview of the taxation of business profits in Canada, see Faye Brown, “An Introduction to Carrying On Business in Canada, Permanent Establishments, and Part XIII Tax,” *Report of Proceedings of Fifty-Sixth Tax Conference*, 2004 Tax Conference (Toronto: Canadian Tax Foundation, 2005), 38:1-20; and Brian Arnold, Jacques Sasseville and Eric M. Zolt, “Symposium: Summary of the Proceedings of an Invitational Seminar on the Taxation of Business Profits Under Tax Treaties,” (2002), vol. 50, no. 6 *Canadian Tax Journal*, 1979-2023.

¹⁵⁰ See David Ward, “Attribution of Income to Permanent Establishments,” 48(3) *Canadian Tax Journal* 559-76 (2000).

¹⁵¹ Article VII(3) of the Treaty. See also *Cudd Pressure Control v. HMQ*, 98 D.T.C. 6630 (F.C.A.) and *Wuslich v. M.N.R.*, 91 D.T.C. 704 (T.C.C.).

¹⁵² Article VII(7) of the Treaty.

royalties, dividends are taxed under Article X, interests are taxed under Article XI, etc. As such, a careful review of the type of income involved will be necessary in order to determine whether and how those types of income would be taxed under the Treaty.

ii) Permanent establishment

Business profits are taxed pursuant to Article VII only if they are attributable to a permanent establishment. In other words, if the U.S. charity earns business profits in Canada but does not have a permanent establishment in Canada, those profits would not be subject to tax in Canada pursuant to Article VII. However, if such income (*e.g.*, interest and royalties) are addressed in other Articles of the Treaty, they may be subject to tax under those provisions.

For example, CRA document number 9219352¹⁵³ involved a U.S. charity proposing to become a limited partner in a limited partnership, which would invest in shares of Canadian corporations. CRA was asked whether the capital gains and dividends the U.S. charity derived from the limited partnership would be subject to tax in Canada. Whether or not the income derived by the U.S. charity through its partnership interest would be subject to Article VII of the Treaty would depend on whether the partnership was considered to have carried on business in Canada through a permanent establishment situated in Canada.

The meaning of permanent establishment is address in Article V of the Treaty. Permanent establishment is defined in Article V(1) to mean a fixed place of business through which the business of a resident of a contracting state is wholly or partly carried on. Therefore, to constitute a permanent establishment, three requirements must be met: (1) there must be a place of business,

facility or premises;¹⁵⁴ (2) that place of business, facility or premises must be fixed; and (3) the business must be carried on through that place of business.¹⁵⁵ A detailed review of the meaning and the application of Article V are outside the scope of this paper.¹⁵⁶ However, the following is a brief summary of some of the key principles that may apply to whether a U.S. charity has a permanent establishment in Canada in determining whether its income may be subject to Canadian tax pursuant to Article VII.¹⁵⁷

- A permanent establishment may be established through the direct ownership and control of facilities by the U.S. entity in Canada or through the U.S. entity having a dependent agency

¹⁵³ Canada Revenue Agency, document number 9219352, October 19, 1992.

¹⁵⁴ Para. 4 of 2003 OECD Commentary to Article 5 indicates that a place of business covers any premises, facilities or installations used for carrying on the business whether or not they are used exclusively for that purpose. A place of business may also exist where no premises are available or required for carrying on the business and it simply has a certain amount of space at its disposal. It is immaterial whether the premises are rented or owned.

¹⁵⁵ Krishna, *supra* note 140 at 33. See also 2003 OECD Commentary to Article 5 at para. 2.

¹⁵⁶ For a detailed review, see Faye Brown, “An Introduction to Carrying On Business in Canada, Permanent Establishments, and Part XIII Tax,” *Report of Proceedings of Fifty-Sixth Tax Conference, 2004 Tax Conference* (Toronto: Canadian Tax Foundation, 2005), 38:1-20; Jas Hayre, CA, “Non-Residents Carrying on Business in Canada,” *2002 British Columbia Tax Conference*, (Vancouver: Canadian Tax Foundation, 2002), 12:1-27.

¹⁵⁷ In Canada Revenue Agency, document No. 9712976, February 18, 1998, when considering what would constitute a “permanent establishment,” CRA indicated that the following factors are relevant:

- There is no need that a “substantial” part of the ordinary business is carried on in the particular place.
- There is no requirement that the business carried on at that place is a separate business different from the business in the resident’s place of the business.
- A “fixed” place of business denotes some sort of permanency, as opposed to temporariness. Control by the U.S. resident over the Canadian premises is not a requirement. It is sufficient as long as the space is at the disposal of the U.S. resident for a considerable length of time.
- The mere presence of employees in Canada does not necessarily render the premises a permanent establishment. Factors such as the nature of the activities carried out the employees in Canada, the duration of those activities, the premises in which those activities were carried out, etc. are relevant considerations.

presence in Canada.¹⁵⁸ A business must be carried on at the place of business, and the place of business must have a degree of permanence and stability.¹⁵⁹

- Pursuant to Article V(2), a permanent establishment includes a place of management, a branch, an office, a factory, a workshop, as well as a mine, an oil or gas well, a quarry or any other place of extraction of natural resources. A permanent establishment also includes a building site or construction or installation project may constitutes a permanent establishment if, but only if, it lasts more than 12 months,¹⁶⁰ as well as the use of an installation, drilling rig or ship in Canada to explore or exploit natural resources, if such use is more than 3 months in a 12 month period.¹⁶¹
- Pursuant to Article V(5), a person (*i.e.*, a dependent agent) in Canada who has, and habitually exercises in Canada, an authority to conclude contracts in the name of the U.S. charity, is considered to constitute a permanent establishment of the U.S. charity. Such a person would usually be referred to an “agent” of the U.S. charity.¹⁶² However, this deemed permanent establishment rule does not apply in a number of scenarios. Firstly, pursuant to Article V(7), this deeming rule does not apply to situations where the person is a broker, general commission agent or any other agent of an independent status (*i.e.*, an independent

¹⁵⁸ Krishna, *supra* note 140 at 33.

¹⁵⁹ See Krishna, *supra* note 140 at 34 and 35 and *Sunbeam Corp. (Canada) Ltd. V. M.N.R.*, [1963] S.C.R. 45, 62 D.T.C. 1390. See also *Dudney v. Canada*, [2000] F.C.J. No. 230, 2000 D.T.C. 6169, wherein the court held that a U.S. citizen and resident who worked in Canada for 300 days in a year did not have a “fixed base” in Canada because he had no control over the premises or office that was made available to him by his customer in Canada. In 2003, changes were made to the OECD Commentary to indicate that a permanent establishment may be created if, in the course of providing consulting or other services to a client, the foreign taxpayer or its employees use the client’s premises for a long period of time. In *Toronto Blue Jays Baseball Club v. Ontario (Minister of Finance)*, [2004] O.J. No. 1751 (S.C.J.), the court held that when the team games in the U.S., the dressing rooms constituted a fixed place of business in the U.S.

¹⁶⁰ Article V(3) of the Treaty.

¹⁶¹ Article V(4) of the Treaty.

¹⁶² Krishna, *supra* note 140 at 36 and 37.

agent), provided that such person is acting in the ordinary course of business. Secondly, Article V(6) provides that a permanent establishment shall be deemed *not* to include a fixed place of business used solely for one or more of the following activities:

- the storage, display or delivery of goods or merchandise belonging to the U.S. resident;
- the maintenance of stock of goods or merchandise belonging to the U.S. resident for the purposes of storage, display or delivery, or for the purpose of processing by another person;
- the purchase of goods or merchandise, or the collection of information, for the resident; and
- advertising, the supply of information, scientific research or similar activities which have a preparatory or auxiliary character, for the resident.

Therefore, when determining whether income earned by a U.S. would can be exempt from Canadian tax because the requirements in Article VII are not met, it would be necessary to review the facts of the case in relation to the U.S. charity, including the source of income earned, how income is earned, the activities of the U.S. charity in Canada, etc. In order to claim this exemption, the U.S. charity would be required to file a T2 corporate income tax return under the Act, together with Schedules 91 and 97 of the T2 return.

b) Non-profit organizations

Lastly, if a U.S. charity does not qualify for exemption under Article XXI(1) (*e.g.*, if the U.S. charity is one of the three categories of charities enumerated in section in 501(c)(3) of the Code but not a “religious, scientific, literary, educational or charitable organization”) or if a U.S. charity is taxable under Article VII (*e.g.*, if the U.S. charity has a permanent establishment in Canada) of the Treaty, it may be exempt from income tax in Canada if it qualifies as a “non-profit organization” (“NPO”)

under paragraph 149(1)(l) of the Act.¹⁶³ Under that paragraph, there are four criteria which must be met.¹⁶⁴

- (a) It is not a charity;
- (b) It is organized exclusively for social welfare, civic improvement, pleasure, recreation or any other purpose except profit;
- (c) It is in fact operated exclusively for the same purpose for which it was organized or for any of the other purposes mentioned in (b); and
- (d) It does not distribute or otherwise make available for the personal benefit of a member any of its income unless the member is an association which has as its primary purpose and function the promotion of amateur athletics in Canada.

This section of the paper will highlight those issues that may be of special interest to U.S. charities operating in Canada. A detailed review of the provisions and the law that applies to NPOs is outside the scope of this paper.

Paragraph 1 of Interpretation Bulletin IT-496R¹⁶⁵ indicates that whether a particular association meets all of these criteria is “a question of fact that can only be determined after” reviewing the “purposes and activities of the association.” CRA clarified that the “determination as to whether a corporation is an NPO takes place on a year-by-year basis, so care must be taken to ensure that the corporation satisfies all the requirements of paragraph 149(1)(l) at all times.”¹⁶⁶

¹⁶³ Canada Revenue Agency, income tax ruling, 9625363, June 27, 1997; Canada Revenue Agency, income tax ruling, 9629653, April 17, 1998; Canada Revenue Agency, income tax ruling, 2005-0139001R3, March 22, 2006.

¹⁶⁴ See also Canada Revenue Agency, *Interpretation Bulletin* IT-496R, “Non-Profit Organizations,” August 2, 2001 at para. 1.

¹⁶⁵ Canada Revenue Agency, *Interpretation Bulletin* IT-496R, *supra* note 164 at para. 4.

¹⁶⁶ See Canada Revenue Agency, document number 2000-0038255, November 2, 2000.

There is no requirement that an NPO must be resident in Canada, as opposed to the requirement that registered charities must be resident in Canada. CRA has confirmed its view in this regard.¹⁶⁷

Therefore, U.S. charities that meet all of the above requirements may be exempt from tax.

If a U.S. charity has a branch office in Canada, the issue is whether the U.S. charity itself would qualify for NPO status, not simply whether the Canadian branch office would qualify for NPO status.¹⁶⁸ In order to determine whether a U.S. charity qualifies as an NPO in Canada, CRA will need to review the governing documents creating the entity in the U.S., including its letters patent, by-laws, memorandum of agreements, articles of incorporation, etc.¹⁶⁹

If a U.S. charity qualifies as an NPO in Canada, it will be exempt from Part I tax.¹⁷⁰ Further, if it has a branch office in Canada, it will be exempt from branch tax under paragraph 219(2)(c) of the Act.¹⁷¹

In relation to the withholding tax under Regulation 105 for services provided by a non-resident U.S. charity, if the U.S. charity qualifies as an NPO, it may apply to CRA for a waiver in respect of such withholding.¹⁷² A U.S. charity that qualifies for tax exemption as an NPO may also apply to CRA for a waiver from Part XIII withholding tax.¹⁷³

¹⁶⁷ Canada Revenue Agency, document number 2001-0095285, November 21, 2001.

¹⁶⁸ Canada Revenue Agency, document number 9625363, June 27, 1997.

¹⁶⁹ *Ibid.*

¹⁷⁰ Canada Revenue Agency, document number 2001-0095285, November 21, 2001; document number 9625363, June 27, 1997; document number 9629653, April 17, 1998; document number 2005-0139001R3.

¹⁷¹ Canada Revenue Agency, document number 2001-0095285, November 21, 2001. Non-resident corporations can carry on business through a branch office in Canada. A branch is not a separate legal entity. Business income of a branch office is subject to Part I tax. In addition, a branch office is also subject to flat 25% a “branch tax” under Part XIV (section 219) of the Act on its after-tax business profits to the extent that the branch office repatriates its profits from Canada. Article X(6) of the Treaty reduces the 25% tax to 5%. The Treaty also exempts the first \$500,000 of branch profits from tax.

¹⁷² *Supra* note 101 and 148. See also Canada Revenue Agency, document number 2001-0095285, November 21, 2001.

¹⁷³ Subsection 212(14)(c)(i) of the Act.

The Act requires that an NPO must not be a charity within the meaning of paragraph 149.1(1)(l) of the Act. Paragraph 4 of Interpretation Bulletin IT-496R indicates that for purposes of this section, “an association may be considered to be a charity even if it is not a registered charity or if its designation as a registered charity has been revoked under section 168” of the Act. This means that (1) the association must not be registered as a charity under the Act; and (2) it must not be a charity at common law even though it may not be registered as a charity under the Act. With respect to the first requirement, in order to qualify for registration as a “registered charity”, the organization must be “resident in Canada and was either created or established in Canada” pursuant to subsection 248(1) of the Act. CRA has indicated that the policy intent of that requirement is that the tax incentives for charities are to be used to support Canadian organizations.¹⁷⁴ Therefore, U.S. charities would not meet this residency requirement and therefore could not become registered charities in Canada.¹⁷⁵

In relation to U.S. entities carrying on operations in Canada, CRA has accepted that a U.S. corporation could be recognized as a charity at common law for the purpose of paragraph 149.1(1)(l) of the Act, although it could not qualify for registration as a registered charity because of the failure to meet the residency requirements of the Act.¹⁷⁶ Therefore, if a U.S. entity is established exclusively for charitable purposes, the fact that it is resident in the U.S. would prevent it from qualifying for registration as a charity in Canada. The U.S. entity would also not qualify as

¹⁷⁴ Canada Revenue Agency, *Employee Speech* CES-001, “Registering a Charity for Income Tax Purposes,” January 30, 1997, at para. 16.

¹⁷⁵ Canada Revenue Agency, *Information Letter* CIL-1994-012, November 18, 1994; Canada Revenue Agency, *Information Letter* CIL-1995-003, February 15, 1995; and Canada Revenue Agency, *Information Letter*, CIL-1999-016, July 26, 1999.

an NPO in Canada by virtue of its charitable objects. It would appear that in those circumstances, the U.S. charity should be exempt from tax under Article XXI(1) of the Treaty, unless it derives income from carrying on a trade or business. If so, the U.S. charity will need to review whether the income would be taxable under Article VII of the Treaty.

D. CONCLUSION

Regardless of the type of activities carried on by U.S. charities in Canada, *e.g.*, soliciting donations, carrying on charitable activities, holding conferences and workshops, selling merchandise to further their charitable objects, etc., it is important for U.S. charities to review how their cross-border operations may be impacted by provisions of the Treaty and the Act.

Although the Treaty does provide some incentives to encourage cross-border charitable giving under Article XXI(6) by Canadian donors to U.S. charities, the relief provided is fairly limited. For those Canadian donors who do not have much or any U.S.-source income, there would not be much incentive for them to make cross-border charitable giving under the Treaty. Other relief provided under the Act for Canadian donors to make cross-border gifts is also very limited in nature. These provisions are usually insufficient for U.S. charities to solicit broad-based donations from the Canadian public.

Income earned by U.S. charities in Canada may be subject to non-resident taxes in Canada unless the income earned is within the exemptions offered by various provisions of the Treaty. In this regard, relief is provided under Article XXI(1) of the Treaty so that certain types of income earned by U.S.

¹⁷⁶ Canada Revenue Agency, income tax ruling, 9900495, August 26, 1999. In this document, the U.S. entity is tax-exempt pursuant to section 501(c)(3) of the Code. It established a Canadian branch office to extend its activities in

charities in Canada are not subject to income tax in Canada. Furthermore, certain income may be exempt from tax pursuant to Article VII of the Treaty by virtue of the income not being business profits derived from a permanent establishment. In addition, exemption from Canadian taxes is also provided if the U.S. charity qualifies as a non-profit organization under the Act. However, there may still be situations where the particular type of income earned by a U.S. charity is subject to income tax in Canada.

As a result, it is important for U.S. charities to carefully review the activities intended to be conducted in Canada with respect to these rules to determine whether the relief provided under the Treaty and the Act is sufficient for their intended operations in Canada. If the relief offered by the Treaty and the Act is not sufficient, then the U.S. charity may wish to consider establishing a parallel tax-exempt charity in Canada. That parallel charity would then apply to become a registered charity in Canada. However, the cost and resources required to establish and maintain a parallel Canadian charity or an international charitable structure may be prohibitive for many U.S. charities. This would especially be the case for smaller charities where the resources required to maintain such an international corporate arrangement is lacking. As such, U.S. charities will require clear rules and guidelines be established in relation to the application of the relevant provisions under the Treaty and the Act in order that they may make determine whether the relief provided under the Treaty and the Act is sufficient.

Unfortunately, the interpretation and application of the relevant provisions of the Treaty are not entirely clear. This is, in part, due to the lack of jurisprudence in this regard, perhaps because

Canada. CRA determined that the U.S. charity is a charity at common law and therefore does not qualify to be an NPO in Canada under the Act.

charities often lack the resources to bring a matter to court. Furthermore, the application and interpretation of the reciprocal provisions of the Treaty in Canada and the U.S. is not consistent by the two contracting countries. For example, IRS allows U.S. charities to rely on Article XXI(5) to make contributes to Canadian charities, while CRA takes the view that Article XXI(6) does not apply to gifts made by Canadian charities to U.S. charities.

Such inconsistency in the interpretation and application of the Treaty provisions is problematic for charities wanting to structure their activities in compliance with the applicable rules. When the activities of charities become more and more international in scope, it is necessary for greater certainty in the interpretation and application of the Treaty be established so that charities may structure their activities accordingly.

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